THE NEED FOR SEC RULES TO GOVERN THE DUTIES AND CIVIL LIABILITIES OF ATTORNEYS UNDER THE FEDERAL SECURITIES STATUTES

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The SEC's filing of the *National Student Marketing* complaint was high drama.[1] Charges that major law firms had participated in a fraudulent plan predictably made the complaint a best seller. The complaint, however, could not detail the SEC's views concerning attorneys' duties under the federal securities statutes and proper division of their loyalties between management and investors. Crucial uncertainties concerning these questions have accumulated. At present the SEC refrains from elaboration, apparently fearing accusations of improper out of court statements on the pending case; but in due course, SEC briefs, new SEC actions, and the decisions of the trial and appellate courts in *National Student Marketing* will clarify the law. My thesis is that this traditional process is too slow and piecemeal. SEC rules specifying attorneys' duties under the federal securities statutes should be drafted and promulgated as a first order of business.

The stakes are large. Securities regulation pivots around the lawyer, and if the SEC perceives that a significant fraction of the securities bar is not properly discharging its duties to investors, the SEC's views should not emerge slowly or in fragments. Ability to act quickly by rule is a prime reason for having an SEC rather than leaving all securities regulation to decentralized private damage and injunctive actions for the enforcement of statutes unsupplemented by administrative rules.

The civil liabilities stakes are also immense. Lawyers have generally conducted securities litigation against issuers, management, underwriters, and accountants, but now they may often be among those asked to contribute to injured investors' rehabilitation. The addition of lawyers has symmetry and may remind the legal profession to take a realistic view of the proper balancing process in determing the civil liabilities of other

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I wish to express my appreciation to John P. Beavers, Esq., a 1972 graduate of the College of Law, Ohio State University. While enrolled in my Seminar on Securities Regulation in 1972, Mr. Beavers prepared an excellent paper on attorneys' duties and responsibilities in the securities registration process. That paper stimulated and sharpened my thinking on many of the points discussed in this article.

[1] *See* Complaint, SEC v. National Student Marketing Corp., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,360 (D.D.C. 1972) [hereinafter referred to as Complaint]; Wall St. J., Feb. 15, 1972, at 8, col. 1. Concerning subsequent action in the case, *see* [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶¶ 93,820, 93,743 (1973); [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶¶ 93,694, 93,581 (1972); [1971-72 Transfer Binder] CCH FED. SEC. L. REP. ¶¶ 93,451, 93,482 (1972); REVIEW OF SECURITIES REGULATION 913-16 (June 7, 1972); BNA SEC. REG. & L. REP. No. 156, A-1 to A-7 (June 14, 1972).

groups. It is worthwhile, however, to prescribe and state the duties of lawyers—hence their exposure to civil liabilities—with some thoughtfulness and clarity so that an optimal allocation of duties among management, attorneys, accountants, engineers, management consultants, and underwriters will result.

In terrorem civil liabilities are overkill if they cause needless duplication among these groups. Accurate information available to all is a condition of the economist's hypothetical perfect market, but it is foolish in the real world to require information at a cost in excess of its worth or to require excessive double-checking in a quest to eliminate all possibilities of inaccuracy.[2] Although the central thrust of federal securities legislation is toward full and accurate disclosure, the cost of producing required disclosures must be a part of the equation used for analyzing that which is required of attorneys.[3]

I have not attempted to formulate a set of rules. The suggested rulemaking proceeding would elicit suggestions and data as a starting point. This article is limited to a discussion of the major uncertainties concerning attorneys' duties in securities work, the extent and desirability of SEC rules, and directions the rules might take.

I. The National Student Marketing Complaint

The SEC's complaint[4] in *National Student Marketing* is a good place to start, for the complaint concretely raises a number of the questions I shall discuss. Its complaint is long and alleges numerous violations by multiple defendants over a substantial period of time. What follows is a summary of the allegations against one of the law firms, White & Case.

According to the complaint, defendant National Student Marketing Corporation (NSMC) and Interstate National Corporation (Interstate), which had approximately 1200 shareholders, entered into an agreement for the merger of the latter into NSMC in exchange for NSMC stock. The closing took place on October 31, 1969; White & Case was NSMC's counsel. Unaudited financial statements, reflecting net earnings of NSMC of approximately $700,000 for the nine-month period ended May 31, 1969, had been included in the proxy soliciting material which was mailed to NSMC and Interstate shareholders in seeking their approval of the merg-

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[2] *See* Demsetz, *Perfect Competition, Regulation, and the Stock Market*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 1, 2-5 (H. Manne ed. 1969).

[3] *SEC Advisory Committee Study on Broker-Dealer Reports and Registration Requirements*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,147 (1972) proposes that more attention be paid to cost-benefit analyses in determining the reports broker-dealers must submit.

This type of close analysis of the duties and civil liabilities of all classes of persons subject to the federal securities statutes would itself be a worthwhile goal for an SEC rulemaking proceeding, but an administrative codification of attorneys' duties is probably the best possible first step, for the attorney's position is pivotal but unique.

[4] Complaint, *supra* note 1.

er. A condition of the merger was the receipt from NSMC's accounting firm of a comfort letter stating that they "had no reason to believe" that the financial statements included in the soliciting material (i) were not prepared in accordance with generally accepted accounting principles and practices or (ii) required any material adjustments for the results of NSMC's operations to be fairly presented. In addition, the comfort letter was to state that NSMC had not suffered any material adverse change in its financial condition or results of operation from May 31, 1969 until five business days prior to the effective date of the merger.

The complaint alleges that the comfort letter did not satisfy the condition in the merger agreement. The comfort letter presented at closing (which had been dictated over the telephone and was unsigned) stated, according to the allegations, that the accountants' examination in connection with the year ended August 31, 1969, which was still in progress, disclosed three expense items (totaling $884,000) which in their opinion should have been reflected in the nine-month financials. The SEC alleges that as part of a "fraudulent scheme" among NSMC, several of its officers, White & Case, Epley (a White & Case partner), several of Interstate's officers, and counsel for Interstate, the merger "was closed on October 31, 1969 without the contents of the comfort letter being disclosed to public investors and the shareholders of NSMC or Interstate even though said defendants knew shareholder approval of the merger had been obtained on the basis of materially false and misleading financial statements of NSMC for the period ended May 31, 1969."[5] According to the complaint, the accountants made subsequent amendments (apparently oral) to the comfort letter on October 31. These amendments were progressively more negative.

The complaint further alleges that "as part of the fraudulent scheme," White & Case issued its opinion letter stating "that all steps taken to consummate the merger had been validly taken and that NSMC had incurred no violation of any federal or state statute or regulation to the knowledge of counsel. Issuance of such an opinion was a condition to the merger, as had been represented to the shareholders of NSMC and Interstate in the proxy statements."[6]

In a summary paragraph the complaint alleges that as a part of the fraudulent scheme White & Case and Epley (i) failed to refuse to issue the opinion; and (ii) failed to insist that the financial statements be revised and shareholders be *resolicited*, and failing that, to *cease representing* NSMC and, under the circumstances, to *notify* the SEC concerning the misleading nature of the nine-month financial statements.[7]

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[5] *Id.* at p. 91,913-16.

[6] *Id.*

[7] *Id.* at p. 91,913-17 (emphasis supplied).

As a practical matter all the allegations in (ii), in connection with actions the SEC alleges were required in addition to refusing to issue the opinion letter, are surplusage. The SEC alleged that the White & Case opinion letter was a condition precedent and had been so represented in the proxy materials. As a matter of fact, a merger agreement can authorize waiver of the opinion. Thus, if the crucial nature of the acquired corporation's right to waive and its intentions at the time of the solicitation regarding waiver are properly explained in the proxy materials, management could presumably waive the opinion at a closing[8] (although the potential for liability to shareholders of the acquired corporation would be large.) Here, however, the White & Case opinion issued, apparently marking the primary basis for the SEC's complaint. If the merger had failed to close for want of an opinion, the SEC would presumably have been satisfied. If the White & Case opinion properly issued, there was no duty, under any theory, for White & Case to take any of the further enumerated steps. The SEC may thus have incurred the wrath of the bar by speaking of withdrawal from representation and notification to the SEC when these matters need not have been mentioned. While the SEC may have been supercautious in its pleading, the resulting diffuseness unfortunately confuses two distinct issues—the legality of giving the opinion and a lawyer's duty to notify the SEC of a client's planned violation. It is the former issue, however, that is by far more important.

The complaint then charges that, again "as part of the fraudulent scheme," White & Case, Epley, and an NSMC officer continued "to conceal the existence of the comfort letter or the contents thereof" in connection with NSMC's 8-K reports for October and November, 1969, which contained representations as to the fairness of the May 31, 1969, financials, and which White & Case transmitted to the SEC.

It is alleged that because of the above-described acts, Epley and White & Case, among others, "singly and in concert, directly and indirectly violated and aided and abetted violations of" § 17(a) of the Securities Act, rule 10b-5, the reporting rules, and rules 14a-3 and 14a-9. The relief requested is a permanent injunction against a wide variety of federal securities acts violations. There is no SEC request for payments to investors.

At first blush, the allegations against White & Case and Epley appear strong. Actual knowledge at closing that the May 31 financials were materially false and misleading is charged. Closing the merger and issuing the firm's opinion are alleged to have taken place as part of a fraudulent scheme; the same is true of the allegations about the failure to insist upon re-solicitation, to cease representation, and to notify the SEC. As our discussion of "materiality" and *Fischer v. Kletz*[9] problems will indicate, how-

[8] *Cf.* Smallwood v. Southdown, Inc., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,435 (S.D. Tex. 1972).

[9] 266 F. Supp. 180 (S.D.N.Y. 1967).

ever, there are numerous factual and legal uncertainties. The SEC charges that the alleged errors in the nine-month financials were material, but preliminary motions in the case have already questioned whether they were in fact material as of October 31.[10] The SEC's complaint also appears to assume that rules 10b-5 and 14a-9 require re-solicitation when a material error in the proxy materials is discovered after the final solicitation—or even after the shareholder vote—so long as it is before consummation of the authorized transaction. Yet we shall see that rule 14a-9 is silent on this precise point.[11] There is, moreover, no allegation of fault or scienter regarding the preparation of the unaudited financials or their inclusion in the proxy materials.

The conclusory allegation of fraud masks basic issues. If White & Case believed its opinion correct, does the SEC intend to charge that its actions were nonetheless "part of the fraudulent scheme"? The ambiguity arises because there is no allegation that White & Case was proceeding in bad faith or was negligent or reckless in opining on the law or the requirements imposed by the merger agreement. We have only the conclusion that the law required re-solicitation and that what was done was part of a fraudulent scheme and thus illegal. The central and thorny issue—the degree of fault or scienter necessary before an attorney's allegedly erroneous conclusion converts him into a violator of the law—is submerged.

II. THE MAJOR UNCERTAINTIES CONCERNING THE DUTIES OF SECURITIES LAWYERS

In summary, the current uncertainties about securities lawyers' duties can be grouped into three categories:

> 1. Those of the type glossed over in the *National Student Marketing* complaint concerning when an attorney's allegedly erroneous conclusion that the securities laws have been satisfied convert him into a violator of those laws.
> 2. Those concerning the responsibility of counsel for the accuracy and completeness of facts in a disclosure document drafted or passed on by him and of facts presented to him as the basis for his favorable opinion on an exemption from some requirement (usually registration of securities) of the securities statutes.
> 3. Those concerning whether counsel for a corporation or other entity also automatically has as his clients the investors and prospective investors in the entity so that his duties in performing securities work for the entity run to the investors and prospective investors as well as the entity.

The securities statutes and the SEC's rules specify little about the lawyer's role and duties. The Securities Act requires inclusion in the registration statement of an opinion of counsel concerning the "legality" of reg-

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[10] *See* REVIEW OF SECURITIES REGULATION 913-16 (June 7, 1972).

[11] *See* text accompanying notes 109-11 *infra.*

istered securities being sold.[12] The SEC's forms expand this to include due authorization, fully paid and assessability status, and the enforceability of debt securities in accordance with their terms.[13] In fact, it is often required that lawyers' opinions on matters such as patents and tax treatment be filed with the registration statement. In giving these limited opinions, the attorney files a formal consent to use and probably has, under § 11 of the Securities Act,[14] duties as an "expert" to all purchasers (whether or not in privity with the attorney) to exercise reasonable care in investigating the facts on which his opinion is based and in applying the law to them.[15] In general, however, there are no explicit governmentally imposed standards for lawyers' preparation of disclosure documents or concerning lawyers' opinions not mentioned in disclosure documents. *Escott v. BarChris Construction Corp.*[16] confirmed that issuer's and underwriters' counsel are not "experts" under § 11 of the Securities Act simply because they have drafted the registration statement. The lawyers held liable in *BarChris* were so held because of their positions as directors, although the court noted that the dual status increased their duties of reasonable investigation as directors.[17]

Insofar as § 11 is concerned, a lawyer, who drafts all of the narrative portion of a registration statement and whose opinion on the "legality" of the registered securities being sold is correct, can walk away from liability for disclosure and other defects in the remainder of the registration statement even if he was negligent or reckless in constructing the statement. This result seems odd when contrasted with § 11's explicit duties of reasonable investigation required of, *inter alia*, directors, underwriters, and accountants and an almost absolute liability for material defects upon the issuer. But the very explicitness of § 11 concerning these other persons

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12 Securities Act of 1933, Schedule A (29), 15 U.S.C. § 77aa (29) (1970). [Hereinafter the Securities Act of 1933 will be referred to as the Securities Act and the Securities Exchange Act of 1934 will be referred to as the Exchange Act.]

13 *See, e.g.*, SEC Form S-1, Instructions as to Exhibits, Item 6, 1 CCH FED. SEC. L. REP. ¶ 7123.

14 Securities Act § 11, 15 U.S.C. § 77k (1970).

15 Liability under § 11 as an "expert" in no event attaches unless the attorney consents to being named as having prepared or certified a part of the registration statement. Securities Act, §§ 11(a)(4), 11(b)(3)(B), 15 U.S.C. §§ 77k(a)(4), 77k(b)(3)(B) (1970). The written consent must be filed with the registration statement. Securities Act § 7, 15 U.S.C. § 77g (1970). The Commission's rules on consents are SEC Rules 435-37, 17 C.F.R. § 230.435-.437 (1972).

In WHEN CORPORATIONS GO PUBLIC 127-28 (C. Israels & G. Duff, Jr., eds. 1962) [hereinafter referred to as WHEN CORPORATIONS GO PUBLIC], it is noted that some counsel consent to use of their opinions but "add at the end of those opinions that by giving this consent they do not admit that they are experts within the meaning of § 11 . . . ." *Id.* Specimen texts in prospectuses concerning experts are found in *id.* at 250-51.

The current and prospective financial interests of counsel in the issuer will usually have to be disclosed in the prospectus. SEC, Guide for Preparation and Filing of Registration Statements, 1 CCH FED. SEC. L. REP. ¶ 3816.

16 283 F. Supp. 643, 683 (S.D.N.Y. 1968).

17 *Id.* at 686-87, 689-92.

seems to support the implicit conclusion of *BarChris* that attorneys, *qua* attorneys, are covered by § 11 only to the extent that they give opinions which they file in the registration statement and with respect to which they file the formal consent to use. The conclusion in *BarChris* (which is implicit) on this point is not askew, because to the degree that a registration statement is "expertised" by the attorney, the § 11 duties of the other participants in the offering diminish sharply. In fact, just that argument was made in *BarChris* by participants other than the attorneys, but Judge McLean rejected it for the reason just stated.

The general antifraud rules, now the heart of federal securities regulation, are the primary governors of attorneys' duties under the federal securities statutes. Attorneys are the draftsmen of securities and disclosure documents, and they, by definition, know the most about the demands of securities regulation. They are also the key men in negotiation processes, and the issuer's counsel usually has had a deep, continuing involvement in the issuer's affairs, thus accumulating considerable information about them. The antifraud rules cut through the privity citadel: rule 10b-5, the antifraud provision of greatest applicability to attorneys' conduct in securities work, proscribes fraud and material misstatements of facts and half-truths of facts by *any* person in connection with any transaction in any security. Attorneys' securities advice and opinions are thus within the reach of rule 10b-5, although attorneys are seldom actual purchasers or sellers.

For example, one who is neither a purchaser nor a seller of a security can be liable to a person who is a purchaser or seller, if the former's fraud, material misstatement or half-truth damaged the seller or purchaser in his securities transaction. Rule 10b-5 applies whether or not the purchase or sale is in the trading markets and whether or not the transaction is covered by § 11 of the Securities Act. Consider then an issuer's counsel, knowing of material defects in a prospectus, but nevertheless opining to an underwriter (in an opinion which, as we shall see, is not a part of the registration statement) that he "knows of no violation of the federal securities laws" in connection with the transaction. The attorney has knowingly made a material misstatement in connection with the sale of a security. Though I know of no case exactly in point, it is clear that although a public purchaser from the underwriter could not collect damages from the attorney under § 11, the purchaser could usually reach the attorney under rule 10b-5.[18] Causation is easily proven as we shall see, because no major securities transaction will close in the absence of a comprehensive, favorable opinion from issuer's counsel delivered to the immediate purchaser (the underwriter in this case).

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[18] *Cf.* Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967); United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied,* 397 U.S. 1006 (1970).

But what is the role of rule 10b-5 if the attorney is only negligent in giving an incorrect opinion to a purchaser? These and other questions about the reach of the antifraud rules are best deferred until an examination of attorneys' duties under ordinary state law principles of contract and tort law to clients and addressees of opinions. As we have already seen, much of the attorney's advice-giving and opinion work never shows up in registration statements and other formal disclosure documents delivered to the public. The world of securities, however, revolves around the lawyer's blessings delivered to direct purchasers (which in a public offering are usually the underwriters) in the form of opinion letters. The extent to which counsel is liable under state law to persons in privity with him for substandard advice or opinions concerning matters regulated by the federal securities statutes may not be sufficiently appreciated. Consideration of these duties will introduce us to the lawyer's role in securities transactions and help to focus the issues under the federal antifraud provisions.

Starting the discussion with state law duties has its disadvantages. What is initially considered is often an amalgam of liabilities under the federal securities statutes and under state law—more specifically, the situation in which the client or addressee is liable to ultimate purchasers under the federal securities statutes and attempts to recover, on a state law negligence theory, from its counsel for substandard investigation, advice or opinions concerning the federal standards. Mixed questions of federal and state law repeatedly present themselves. Just as corporation law and securities regulation have become inextricably intertwined, state law negligence considerations applicable to attorneys' corporate and securities work cannot be separated from the bodies of substantive law governing that work. But examination of all seamless webs must start somewhere, and I am convinced that examination of uncertainties under state law provides the best initial illumination.

Treatment of uncertainties under state law can be only an informed speculation. Indeed, the paucity of malpractice recoveries for errors of judgment and the almost total absence of cases concerning substandard securities work have led one student commentator on the *National Student Marketing* complaint to conclude that there is little danger to securities lawyers lurking in state malpractice law.[19] Yet some first-rate articles are beginning to appear on these questions,[20] indicating a developing belief (which I believe to be correct) that securities lawyers are foolish if they

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[19] Note, *Securities Regulation—Attorneys' Liability—Advising, Abetting, and the SEC's National Student Marketing Offensive*, 50 TEXAS L. REV. 1265, 1271-72 (1972).

[20] *See, e.g.*, Cheek, *Counsel Names in a Prospectus*, REVIEW OF SECURITIES REGULATION 939-46 (April 5, 1973); Fuld, *Legal Opinions in Business Transactions—An Attempt to Bring Some Order Out of Some Chaos*, 28 BUS. LAW. 915 (1973); Lathrop & Rinehart, *Legal Malpractice and Rule 10b-5 Liability: Pitfalls for the Occasional Securities Practitioner*, 5 LOYOLA L. REV.—L. A. 449 (1972) [hereinafter referred to as Lathrop & Rinehart].

believe they are above or beyond the practical reach of state malpractice law.

A. *Uncertainties Under State Law*

1. The Scope of the Lawyer's Engagement and His Opinion

In a major securities transaction outside the trading markets, the direct purchasers (which in a public offering are usually the underwriters) commonly require a comprehensive, formal, written opinion addressed to them from both their counsel and the issuer's counsel.[21] The opinions go well beyond what the securities law would require. Indeed, in an unregistered offering there is no securities law requirement for a legal opinion, and in a registered offering the opinions required by the Securities Act to be included in the registration statement are limited in scope.[22] Purchasers in major transactions, however, insist upon the opinion of their counsel and issuer's counsel on numerous legal points about the securities, and the issuer's business, assets, and liabilities.[23] These opinion letters are not included or required to be included in the registration statement in a public offering. The opinions include matters which would be included in the absence of securities regulation (for example, the legal attributes of securities being purchased and due organization and existence of the issuer) in opinion language that seems to obligate counsel under state contract and tort law to make non-negligent determinations of the facts on which the legal conclusions are based as well as of the legal conclusions themselves.

A form of opinion that seems clearly to obligate counsel to use reasonable care in determining the facts on which his legal conclusion is based is one specifying counsel's close relationship to the issuer (perhaps he has been general counsel), enumerating some of the documents examined, and stating that counsel has also examined such corporate records as deemed necessary for the opinion. This type of explicit preamble is not uncommon,[24] but as it is watered down or made less explicit, there may be nice questions as to counsel's undertaking with respect to the factual basis for an opinion. We shall see that on certain matters, counsel's opinion will attempt express limitations upon fact-vouching or upon a duty of factual investigation. Sophisticated purchasers will of course try to obligate counsel to give an opinion covering the factual base. For example, an opinion

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21 For a form of opinion of issuer's counsel, *see* WHEN CORPORATIONS GO PUBLIC, *supra* note 15, at 312-16. The matters on which issuer's and purchaser's counsel will opine are usually specified in the purchase or underwriting agreement.

22 *See* notes 12-15 *supra* and accompanying text for opinions required by the Securities Act.

23 *See* the form of opinion in WHEN CORPORATIONS GO PUBLIC, *supra* note 15, at 312-16.

24 *See* WHEN CORPORATIONS GO PUBLIC, *supra* note 15, at 312-13, for an example of such a preamble.

on the nonassessability of stock is worth little if counsel could exclude a study of the charter. For now the discussion will be restricted to opinions requiring a reasonable investigation of the factual base.

Consider issuer's and purchaser's counsel opining, to a person who purchases from the corporation in an unregistered private offering, that the stock is non-assessable while the charter (which because of neglect is not checked by either counsel) states that the stock is assessable and local law renders it assessable in that limited circumstance. This would be about as clear a case of negligence (failing to check the charter) as one could imagine, and if the purchaser is forced to pay an assessment, one cause of action is the straightforward one against both counsel under state law for negligence. Other possibilities abound. Perhaps the purchaser can rescind under state law, rule 10b-5, or § 12(2) of the Securities Act. The attorneys' negligent statement in their opinion letters may render them liable to the purchaser in damages under rule 10b-5. But the actions under rule 10b-5 or § 12 against the attorneys may be difficult.[25] The purchaser's best action against the attorney is probably the simple one under state law.

It is this cause of action—the straightforward one under state law for negligence—which I am discussing in this portion of the article; and indeed, the lawyer's exposure may be greatest under this theory.[26] I am al-

[25] First, is an erroneous opinion a misstatement of fact? It clearly is if the opinion giver does not believe the opinion correct, for his state of mind is misrepresented. But to convert an erroneous opinion given in good faith (but after negligent research) into a misstatement of fact requires that the theory of implied representation be mobilized. An opinion is not a warranty or a flat statement that the opined matter is true. In the securities field the theory of implied representation is widely used to impose desired duties upon professionals connected with the sale and trading of securities. Perhaps an attorney giving a securities opinion impliedly represents to the recipient that reasonable care has been used in preparing the opinion and a failure to use reasonable care is thus a misrepresentation of a material fact. Even if, however, an implied representation concept is applicable, the type of care impliedly represented is not self-evident. Especially in the Second Circuit there is still considerable talk about required culpability beyond ordinary negligence before a material misstatement of fact violates rule 10b-5. *See* Lathrop & Rinehart, *supra* note 20, at 470-75. For a comprehensive discussion of scienter and fault standards, see Chris-Craft Industries, Inc. v. Bangor Punta Corp., CCH Fed. Sec. L. Rep. ¶ 93,816 (2d Cir. 1973).

Section 12(2) reaches material misstatements resulting from ordinary negligence, but the section applies only to one who "sells" securities and it may be doubtful whether the attorneys "sold" within the meaning of that section. *See* text accompanying notes 121-28 *infra*.

Furthermore, § 12(2) probably would not allow damages in an amount greater than the purchase price. This would seem to follow from the limitation to "the consideration paid for such security with interest thereon . . . , upon the tender of such security, or for damages if [the purchaser] no longer owns the security." Securities Act § 12(2), 15 U.S.C. § 77*l*(2) (1970). In the hypothetical posed in the text, the application of this limitation is not so clear, for the assessments themselves could conceivably be deemed consideration paid for the security.

[26] The best works pointed toward the securities lawyer are Lathrop & Rinehart, *supra* note 20; Karmel, *Attorneys' Securities Laws Liabilities*, 27 BUS. LAW 1153 (1972) [hereinafter referred to as Karmel]; Freeman, *Liability of Counsel for Issuer*, and Henkel, *The Liability of Counsel for Underwriter*, in *The BarChris Case: Prospectus Liability*, 24 BUS. LAW. 523, at 635, 641 (1969) [hereinafter referred to as Freeman and as Henkel, respectively].

For an excellent general coverage of malpractice, see Comment, *Professional Negligence*, 121 U. PA. L. REV. 627 (1973); Comment, *Attorney Malpractice*, 63 COLUM. L. REV. 1292 so placing to one side for a moment the question of an attorney's liability to persons who are not clients or addressees of opinions.[27] As we shall see, at least the issuing corporation's counsel may soon be considered counsel for the entity *and* its shareholders *and* prospective shareholders, thus placing him in privity with everyone who may be injured by his negligence or culpability in his securities work.[28] But that is a separate chapter; this section is limited to clients and addressees of opinions.

The Code of Professional Responsibility prohibits attempted limitation of liability to the client for the attorney's personal malpractice,[29] which could include the liabilities of issuer's counsel to purchasers. The very purpose of having the opinion of issuer's counsel addressed to the purchasers is to cut the privity knot. Commonly, the purchasers also have their own counsel, and in negotiation of terms I doubt that many persons would think that issuer's counsel is representing anyone other than the issuer. On the matters covered by the opinion, however, the relationship between issuer's counsel and the purchasers may be one of attorney and client.[30]

The opinions issued to purchasers in major securities transactions also cover, to a limited extent, compliance with securities statutes and regulation. A customary opinion to underwriters is that the *form* of the disclosure documents (excluding financials, about which attorneys seldom consciously[31] opine) comply in all material respects with the statutes and the SEC's rules; this matter, as well as the others we have discussed, is covered in normal opinion language that obligates counsel to make non-negligent determinations of the facts on which the legal conclusions are based as well as of the legal conclusions themselves.[32] Attorneys do not appreciate the degree to which (I believe) the unqualified opinion on "form" may obligate them as to facts. The "qualify in form" language clearly does not go to the absence of material misstatements or half-truths, but it may force an attorney to investigate facts to determine if there is coverage in form of all items required by the SEC's rules to be stated. If there is no (or limited) discussion in a prospectus of an item specifically required to be disclosed, doesn't the attorney's unqualified opinion that the

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(1963). In fact, there is relatively little case law or empirical data on attorney malpractice. Note, *Improving Information on Legal Malpractice*, YALE L. J. 590 (1973).

[27] Since California usually pioneers in expanding tort remedies, Lathrop & Rinehart, *supra* note 20, is strong on this point. Freeman and Henkel, *supra* note 26, discuss the issue from more traditional vantage points.

[28] *See* text accompanying notes 83-99 *infra.*

[29] ABA CODE OF PROFESSIONAL RESPONSIBILITY, DISCIPLINARY RULES 6-101, 6-102.

[30] If the fact that the opinion is addressed to the purchaser is not enough to create an attorney-client relationship with respect to matters covered by the opinion, the case law on the duties of corporate counsel to prospective shareholders may create the relationship. *See* text accompanying notes 83-99 *infra.*

[31] Attorneys may unconsciously opine on some financial data, if the data is presented or required to be presented outside the certified financials. *See* text accompanying notes 57-60 *infra.*

[32] *See* WHEN CORPORATIONS GO PUBLIC, *supra* note 15, ¶ (10), at 315-16.

registration statement and prospectus comply in form require him to investigate the facts at least sufficiently to indicate that the absence of discussion or limited discussion seems justified?

Consider a simpler case: Issuer's counsel, underwriter's counsel, and the underwriter all know of certain information omitted from the registration statement. The underwriter asks both counsel whether the SEC's rules require inclusion. Both say no and their opinion letters state that in their opinion the registration statement complies in form in all material respects. Suppose the attorneys are wrong; the applicable SEC form clearly required inclusion, and the SEC's forms are part of its rules.[33] Assume further that the omission is material. Under § 11, if there is a material omission, it matters not whether the omission is in the prospectus or in the other documents required to be filed as part of the registration statement.[34] If the underwriter is held liable, under § 11(a), to public purchasers (a nice question in light of its reliance upon counsel[35]), the underwriter cannot sue the attorneys under § 11. The underwriter, however, was in privity with both counsel; both addressed their opinions to the underwriter. Under state law, the underwriter should have a near-perfect negligence action against both counsel.

The question is not entirely one of state law, however. The *Globus* litigation[36] established that an underwriter liable to a public purchaser for a material misstatement in a prospectus cannot enforce an indemnification agreement against the issuer if the underwriter knows of the material misstatement. This result obtains as a matter of federal law, although an indemnification right, as opposed to a right to contribution,[37] for liabilities under the federal securities statutes appears to exist only if a contractual right under state law has been created. *Globus* held that the federal securities statutes would be frustrated if an underwriter with knowledge of a material misstatement could enforce a contractual indemnification right,

33 *See* 17 C.F.R. § 239.0-1(a) (1972).

34 Securities Act § 11 cases seem invariably to involve alleged defects in the prospectus, but § 11 explicitly refers to defects in the registration statement (of which the prospectus is only a part).

35 As I read Escott v. BarChris Construction Co., 283 F. Supp. 643, 692-97 (S.D.N.Y. 1968), the failures of an underwriters' counsel in investigating facts are the underwriters' failures. The opinion, however, seems to indicate that a different case might be presented when an underwriter relies upon counsel's legal advice. *Id.* at 697. But should an underwriter be allowed, for § 11 purposes, to rely almost conclusively upon counsel's legal advice when that advice is not a part of the registration statement and not given by counsel as a § 11 expert?

36 Globus, Inc. v. Law Research Services, Inc., 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd in part and rev'd in part*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); Globus, Inc. v. Law Research Services, Inc., 318 F. Supp. 955 (S.D.N.Y. 1970), *aff'd per curiam*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971). *See* Note, *Globus: A Prolific Generator of Nice Questions*, 33 OHIO ST. L.J. 898 (1972).

37 Securities Act § 11(f) itself creates a specified right to contribution in respect of § 11 liabilities. 15 U.S.C. § 77k(f) (1970). On the emerging general federal law concerning contribution and indemnity among joint tort-feasors violating a federal statute, see Note, *supra* note 36.

for the underwriter would have less incentive to force issuers to issue truthful and complete prospectuses.[38] The last *Globus* case[39] held that the Securities Act itself would allow contribution among several participants if all of them had knowledge of the disclosure defect.

Where does *Globus* leave our hypothetical underwriter, which knew of the omitted facts, but which had been assured by both counsel that omission was proper under the SEC's rules? Does *Globus* indicate that the Securities Act precludes assertion of the state law negligence claim against the attorneys because it would be tantamount to an indemnification and the underwriter had knowledge? I think not. Our underwriter was acting in good faith and its reliance upon counsel, if not satisfying the due diligence standard of § 11,[40] was not unreasonable. No Securities Act policy would be frustrated by the underwriter's recovery against the attorneys.

The *Globus* case demonstrates, however, that state law remedies against attorneys cannot be considered wholly apart from the federal securities statutes. If the client or addressee of the opinion knows that the attorney's advice is wrong or suspect, there may be insufficient reliance upon the opinion to support recovery under a state law negligence theory. To a large extent, the limitations in *Globus* simply parallel that principle, but I am not sure that there is congruence.

When the issuer is held liable under the federal securities statutes for a defective disclosure document or failure to register securities and attempts to recover from its attorney for his negligence in preparing the document or erroneously advising that an exemption was available, the *Globus* issue becomes even more interesting. If the issuer was held liable under § 11 or § 12(1) of the Securities Act, the liability was imposed under provisions that create near-absolute issuer liability. Is an attempted shift of the liability to the attorney under a state law negligence theory a forbidden attempt to secure indemnification? Again the issuer's culpability is important. If it knew or suspected that the disclosure document was incomplete or that the exemption was unavailable, the state law action should stumble on the causation element, mooting the *Globus* question. If, however, the issuer was pure, should the action over under state law nevertheless be precluded as contrary to the policies of the federal securities statutes? On the other hand, wouldn't a stifling of claims against attorneys in this situation diminish attorneys' incentives for careful work and advice?

Usually, purchasers also insist upon as much assurance as possible from attorneys that the facts stated in disclosure documents, for example, a pro-

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38 Globus, Inc. v. Law Research Services, Inc., 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd in part and rev'd in part*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

39 Globus, Inc. v. Law Research Services, Inc., 318 F. Supp. 955 (S.D.N.Y. 1970), *aff'd per curiam*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971).

40 *See* note 35 *supra* and accompanying text.

spectus (or an offering circular or letter in an unregistered offering), contain no material misstatement or half-truth. Attorneys have always taken the position, so far successfully, that they will not give a normal opinion (that in their opinion the documents contain no material omission or half-truth).[41] Such an opinion would place lawyers in much the same position vis-à-vis the whole disclosure document as accountants occupy vis-à-vis certified financials, for the lawyers would be obligated to conduct a reasonable investigation of all the issuer's business, affairs, assets, and liabilities. Such a far-ranging duty of investigation has been rejected by lawyers. Rather, lawyers will state in their opinions to purchasers only that they *know* of no material misstatement or half-truth,[42] and the financials are often excluded from even this negative assurance ("comfort") language.[43] An alternative formulation, obviously more expansive, is to represent that counsel "knows" of no violation of the securities laws.[44] Let us assume, for the time being at least, that these forms of limited negative assurance on facts are not inconsistent with the federal securities statutes.[45]

From the form of the opinion, one might think that lawyers have limited the scope of their engagement and thus worded their way out of any possible liability based upon either a claim by a client or an addressee of an opinion or a failure to perform agreed-upon or otherwise required investigation of the accuracy of the disclosure documents. In fact, however, ambiguities abound, and I believe the exposure of corporate counsel to the corporation and purchasers, and of purchasers' counsel on this point to his clients, may be much greater than has been assumed. Both counsel inevitably perform some factual investigation,[46] and it is usually unclear how much investigation counsel has agreed to perform. The opinions that do not directly bear upon securities regulation will require some factual verification. Counsel (especially the issuer's counsel) are usually the field captains in a securities transaction, and disclosure documents are given their final form by counsel. Most importantly, issuers and many purchasers expect their respective counsel to undertake considerable, but unspecified, investigation. It would not surprise me to learn that a majority of issuers consciously or unconsciously look to their counsel to ensure that counsel

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41 *See* WHEN CORPORATIONS GO PUBLIC, *supra* note 15, ¶ (10) at 315-16; Dean, *The Lawyer's Problems in the Registration of Securities*, 4 LAW & CONTEMP. PROB. 154, 181-82 (1937) [hereinafter referred to as Dean].

42 The formulation in WHEN CORPORATIONS GO PUBLIC, *supra* note 15, at 312-16, is more demanding. In the pertinent provision of the opinion (paragraph (10)), the attorneys opine that they "have no reason to believe" there is a material misstatement or half-truth.

43 *See* WHEN CORPORATIONS GO PUBLIC, *supra* note 15, ¶ (10) at 315-16.

44 According to the SEC's allegations in the Complaint, *supra* note 1, this was the form of the opinion of issuer's counsel. *See* notes 4-11 *supra* and accompanying text.

45 Concerning duties of factual investigation imposed upon counsel by the federal securities statutes, see Part II(E) of this article, *infra.*

46 *See* WHEN CORPORATIONS GO PUBLIC, *supra* note 15, at 121-28, 157; Henkel, *supra* note 26, at 641.

and company personnel together undertake a reasonable investigation of all facts necessary to be disclosed.[47]

I believe that most issuer's counsel would disagree with this statement of their charge and would point to the wording of the opinion to the purchaser as evidence of a much lesser charge. If the issuer's counsel on a securities matter is the corporation's general counsel, the most formal record of counsel's intended role may be his statement (bill) rendered after the transaction. The statement will always reflect considerable factual investigation. Though the most comprehensive opinion rendered by issuer's counsel will be to the underwriter, counsel is working for the issuer, whose general expectations are communicated—giving an optimal blend of: (i) speed in drafting papers and disclosure documents, qualifying the issue for sale, and closing the sale; and (ii) protection from liability. Refined questions such as the allocation of responsibility for factual accuracy and completeness between counsel and company personnel are often left unsettled or never explicitly raised. The potential for arguable attorney liability to the issuer if the issuer is found liable for defective disclosure documents and cross-claims against the attorney under a state law negligence theory is obvious.

There is a similar possibility of misunderstanding between the purchaser and its counsel concerning counsel's role in factual investigation, but the probability is less since the purchaser's counsel is a stranger to the issuer and historically has investigated less than issuer's counsel.

These ambiguities concerning counsel's role in factual investigation would, one might think, long ago have caused lawyers to work on securities sales only pursuant to a detailed engagement letter specifying what counsel would and would not do, for the form of the opinion letters (no knowledge of material misstatements or half-truths) should not be trusted to carry the day if strong contrary evidence of expected factual investigation exists. Counsel have, however, badly represented themselves, as such engagement letters have been rare. In an analogous situation, the preparation of unaudited statements, the decision in *1136 Tenants' Corp. v. Max Rothenburg & Co.*[48] has made accountants aware of the value of detailed engagement letters in combating malpractice actions.[49]

There is, furthermore, an ambiguity in the phrasing of counsel's opinion on the antifraud question—that counsel does not know of a material misstatement or half-truth—because "know" or "knowledge" is not defined. The term presumably means actual knowledge. Since, however,

47 This is only my personal impression.

48 36 App. Div. 2d 804, 319 N.Y.S.2d 1007 (1971), *aff'd without opinion*, 30 N.Y.2d 585, 281 N.E.2d 846, 330 N.Y.S.2d 800 (1972). *See* Note, *Certified Public Accountants' Liability for Unaudited Financial Statements*, 8 CALIF. WEST. L. REV. 368 (1972).

49 Much of the December, 1972, issue of the *Journal of Accountancy* is devoted to engagement letters and unaudited statements.

counsel performs some factual investigation, an alternate meaning, that from all of the facts known to him he has reason to know, is surely possible.[50]

Other uncertainties about counsel's engagement arise because of abbreviated descriptions in prospectuses of counsel's role. Though apparently not required by the Securities Act or the SEC's rules, customarily included in a prospectus is a caption listing counsel for the issuer and the underwriters' counsel and briefly mentioning what they have done. The form of description of counsel's work varies. Sometimes it is stated that counsel has passed upon the "legality" of the issue or that counsel has passed upon Securities Act matters;[51] both formulae are inexplicit. One who has not seen the actual opinions might think that "legality" would necessarily comprehend full compliance with the Securities Act. And an attorney who writes a prospectus stating that he has "passed upon" Securities Act matters ought to realize that a not unnatural interpretation by persons having no access to the opinions would be that counsel's opinion covers the factual accuracy of the prospectus.

Though these formulae have been used in prospectuses for so long that they are probably immune from attack as materially misleading, it would be preferable to specify the limited scope of the matters that counsel have passed upon. The most sophisticated public purchasers know the limits of counsel's opinion, but a moderately sophisticated public purchaser might believe that one or both counsel have passed upon the factual accuracy of the prospectus. The point may be material, and it would be unfortunate if the portion of the prospectus describing the functions of counsel were found materially misleading; the attorney's liability under state law over to the issuer and the underwriters after the latter have paid under § 11 would seem relatively automatic. Moreover, a failure in the prospectus to describe the limited scope of counsel's work aggravates counsel's problems in persuading clients that counsel's responsibility for factual accuracy and completeness is as limited as his opinion indicates.

A current uncertainty revolves around the use of the term "General Counsel" in public reports and documents to describe the corporation's relationship with its outside law firm. In *Black & Company v. Nova-Tech,*

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[50] In the opinion letter reprinted in WHEN CORPORATIONS GO PUBLIC, *supra* note 15 ¶ (10) at 315-16, the pertinent portion words this opinion in terms of counsel's "having no reason" to believe there is a material misstatement or half truth. This formulation seems to include a deficiency of which counsel has reason to know, based upon facts known to him.

For discussion of this inquiry notice issue as it arises in the context of the antifraud rules, see Part II(E) of this article *infra.*

[51] WHEN CORPORATIONS GO PUBLIC, *supra* note 15, at 250-51 gives a specimen text of the discussion in a prospectus of counsel's status as an expert with reference to title to an important piece of real estate.

Concerning use of counsel's name in a prospectus, see Cheek, *supra* note 20. See also Fuld, *supra* note 20.

Inc.,[52] the issue was whether California counsel were amenable to service of process in Oregon with respect to an allegation that the client's sales of unregistered securities in Oregon violated that state's securities laws. The court stated that the law firm's designation in the client's published reports as the client's corporate counsel was enough for purposes of the Oregon Securities Law "to make the firm's partners 'participants' in any unlawful securities transaction in which the annual reports were used for promotional purposes."[53] This is surely hyperbole, even under the sweeping Oregon authority relied upon by the court, but designations such as corporate counsel or General Counsel do imply a continuing, deep involvement in the client's affairs.

2. The Duty to Reveal Doubts

Yet another uncertainty arises from securities lawyers' practice of affirmatively opining in unqualified language without mentioning or evaluating substantial possibilities of a different answer. For example, if the sale is made in reliance upon an exemption from registration (such as the private offering exemption), cautious issuers and participating broker-dealers will require written opinions of counsel concerning the availability of the exemption. Counsel's favorable legal conclusion on a close question will usually be as unqualified as if there were an overpowering case for the exemption (say, the sole proprietor of the corner adult book store incorporates as the only shareholder). In response to the demands of purchasers and clients, the practice of securities lawyers in giving written opinions—especially to purchasers—is usually to banish doubt. Though it often would be truthful to say that, for example, there is an estimated 60-40 probability of success in litigation, this form of opinion is almost never issued to a purchaser, but counsel for the issuer may come close to telling the issuer that this is the fact. Either the opinion issues "clean" or it never emerges; this is so even with respect to the private offering exemption, whose legal definition is almost formless. In prospectuses, if counsel consents to description of, say, his tax opinion (which, by such consent, will probably subject the attorney to the duties of an "expert" under § 11 of the Securities Act), substantial uncertainties will be flagged. Furthermore, blue sky opinions to underwriters commonly state the uncertainties.[54] The bar apparently assumes, however, that when they deal with a puzzle in other contexts, their "clean" opinions represent only that the indicated result is more likely than not and that substantial uncertainties or authori-

[52] 333 F. Supp. 468 (D. Ore. 1971).

[53] 333 F. Supp. at 472.

[54] See the various blue sky memoranda set out in L. LOSS & E. COWETT, BLUE SKY LAW 96-122 (1958). One memorandum states, "Accordingly the information furnished herein must be regarded as a practical guide rather than an opinion from us with respect to the laws of the jurisdictions concerned." *Id.* at 96.

ties looking in the opposite direction need not be disclosed in their opinion. While the recipients of such opinions are usually sophisticates who probably understand this convention, a laconic favorable opinion on a puzzle may not be the best starting point if the recipient of the opinion relies upon it, is found liable under the securities statutes, and charges that attorney with malpractice on the theory that had the recipient known of the considerable uncertainty he would have chosen a safer alternative.[55]

3. Divison of Labor and Overlapping

Most of these uncertainties are of attorneys' own making and they can remove them through the type of detailed, cautious approach now recommended for accountants in engagement and comfort letters.[56] Inexplicitness in these areas is not, however, solely lawyers' private concern. For example, in an underwriting covered by the Securities Act, an explicit division of labor between counsel and others is in the public interest as well as the lawyer's private interest. Since at least the managing underwriter must make a reasonably comprehensive investigation and since the issuer is an absolute insurer, what the attorney expressly excludes from the scope of his investigational responsibilities should and will likely be covered by others. A misunderstanding on allocation of responsibilities, on the other hand, can lead the best-intentioned team to miss important areas.

Another danger for attorneys is that their attempted exclusion of the financials from their opinions is probably ineffectual, for a sharp division between the financials and narrative disclosures no longer exists. *Gamble-Skogmo*[57] established that where certified financials may properly exclude, or be required to exclude, figures not compatible with generally accepted accounting principles (for instance, because the figures are not based upon historical costs), the disclosure document in which the financials are used can violate the antifraud rules for failure to include in the narrative portion the excluded figures and their significance if they are material to the transaction.[58] Under this formulation, the attorney must ensure that the narrative portion properly describes such figures excluded from the financials and their significance and that to his knowledge the description contains no material inaccuracies or omission. His opinion at closing, that he knows of no material misstatement or half-truth in the narrative portion, and his duties to his client (clients?) require as much. Even if his opin-

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[55] *See* text accompanying notes 62-63 *infra.*

[56] *See* note 48 *supra* and accompanying text; *AICPA,* STATEMENT ON AUDITING PROCEDURE NO. 48, LETTERS FOR UNDERWRITERS (1971). See also Cheek, *supra* note 20; Fuld, *supra* note 20.

[57] Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (E.D.N.Y. 1969).

[58] *See* 298 F. Supp. at 91 n.6, 92, 101; *accord,* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971). For an excellent article on "soft" figures and other "soft" information, *see* Schneider, *Nits, Grits, and Soft Information in SEC Filings,* 121 U. PA. L. REV. 254 (1972).

ion excludes the financials he is not aided, for the defect would appear in the narrative portion.

United States v. Simon[59] establishes related propositions: (1) that actual absence of a good faith belief that certified financials make a fair presentation can constitute criminal scienter by the certifying accountant; and (2) fair presentation is not always established by adherance to generally accepted accounting principles: a common sense gloss must be applied for crucial, unusual items of which the accountant has knowledge. The *Simon* approach differs somewhat from *Gamble-Skogmo* in that *Simon* indicates that the accountant must sometimes cause the financials to be supplemented with information not required by generally accepted accounting principles before he issues his favorable opinion, but the two approaches are not inconsistent. In *Gamble-Skogmo* and other cases of its kind, the accountants were not the plaintiff's target, whereas *Simon* was a criminal prosecution against the accountant. The cases establish an overlapping responsibility between accountants and others to ensure that figures presented in accordance with generally accepted accounting principles do not create a material half-truth. The overlap expands the attorney's duties as more and more data in the financials must be supplemented in the narrative portion of disclosure documents.[60]

B. *Uncertainties Caused by Expanding Materiality Concepts*

Another major uncertainty about counsel's opinion that he knows of no material omission or half-truth results from the significant, recent expansion of the "materiality" concept. Counsel knows many facts not stated in the disclosure documents and numerous elaborations and qualifications that might be added to the facts presented in them. The federal securities statutes, however, contemplate readable and comprehensible summaries

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[59] 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

[60] In some opinion letters, it will be a nice question of interpretation whether the exclusion of financials from counsel's opinion is broad enough also to exclude figures required to be disclosed in the narrative portion of the statement (or required to be disclosed there if not disclosed in the financials themselves).

In the pertinent provision of the opinion letter in WHEN CORPORATIONS GO PUBLIC, *supra* note 15, ¶ (10), at 315-16, there is excepted from the opinions on "compliance as to form" and absence of material half-truths and misstatements, "the financial statements schedules and other financial data" included in the prospectus. I doubt that this is much protection. An appraisal, engineer's report, or geologist's report would seem not excluded. The "surplus surplus" of the acquired company in Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971), is a closer question, though a narrative explanation seems to have been what the court contemplated, and a narrative explanation with a few figures included is probably not "financial data." Likewise if a company must disclose dismal operating and financial projections for the forthcoming year or so, a narrative form would predominate, and surely material describing the business, capitalization, and conflict of interest transactions is not "financial data."

An even more basic question is whether the language quoted in the immediately preceding paragraph excludes narrative material (primarily footnotes) in the certified financials and other primarily financial schedules.

rather than catalogs stuffed with detail.[61] Proper exclusion, cutting and trimming is a major step in producing a good disclosure document that is both readable and comprehensible. With the materiality test rapidly losing its content, however, the attorney's judgment that items can be omitted as immaterial becomes an increasingly dangerous exercise. In malpractice actions, a good faith, informed judgment regarding an unsettled body of law creates no liability, whether or not the courts ultimately agree with the lawyer's opinion.[62] But counsel could conceivably be liable to his clients for damages resulting from his choice of a riskier method or proceeding as opposed to a proven, safe alternative.[63] Should counsel, therefore, be ultracautious in omitting information, especially since he is opining that there are no material omissions or misstatements? This question can no longer be taken lightly. Though it will carry us somewhat afield, it is worthwhile at this point to examine what has happened to the materiality test in recent decisions.

The concept of what constitutes a material fact determines, perhaps more than any other test, the demands of the federal securities statutes and one's exposure for disclosure defects. In every press release, report, prospectus and proxy statement there can be found omissions, misstatements and half-truths, no matter how careful the preparers are. Describing the history, health, results of operations and prospects of anything so complicated as a business and its interactions with the world is difficult (especially in a summary document) and is a process done differently by equally qualified persons. One lawyer or accountant can always look at the work of another and find omissions, misstatements and half-truths. The material fact limitations in various requirements of the securities laws should limit redress to instances of omissions or misstatements about essentials, which are of necessity rather limited in number.[64] The material fact limitations should also provide the direction and protection necessary for the prepar-

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[61] *See, e.g.*, SEC Form S-1, General Instruction D(a), 1 CCH FED. SEC. L. REP. ¶ 7122:

> The purpose of the prospectus is to inform investors. Hence, the information set forth in the prospectus should be presented in clear, concise, understandable fashion. Avoid unnecessary and irrelevant details, repetition or the use of unnecessary technical language.

The WHEAT REPORT, SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 77-80 (1968) states that the SEC's goal is that the prospectus be a summary. Because of a fear the courts would interpret the term "material fact" expansively—a fear that has now been realized—cautious counsel, however, have often summarized at length rather than briefly. *See* Dean, *supra* note 41, at 157-61.

[62] Wade, *The Attorney's Liability for Negligence*, 12 VAND. L. REV. 755, 763-64 (1959) [hereinafter referred to as Wade]. *Cf.* Lucas v. Hamm, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961), *noted in* 75 HARV. L. REV. 620 (1962).

[63] *See* Wade, *supra* note 62, at 764-65 (citing English cases). *Cf.* Dean, *supra* note 41, at 160-61.

[64] For a hypothesis that, at least in a public company, only a few items of accounting data are crucial, see Benston, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23, 31-41 (H. Manne ed. 1969).

ation of concise documents. It is on essential matters that investigators, draftsmen and regulators should concentrate. To the extent that materiality becomes all-encompassing, essentials may receive less attention; even the disclosure documents intended for general consumption will become catalogs; and every investment loss becomes a potential lawsuit as experts ferret out little facts that were omitted or imprecisely stated in a disclosure document.

In most of the classic cases under the securities statutes, the alleged deficiencies in disclosure have involved essentials—the proposed purchase of the corporate assets in *Kardon v. National Gypsum Co.*;[65] the tremendous inventory appreciation soon to be realized in *Speed v. Transamerica Corp.*;[66] the potentially historic mineral discovery in *SEC v. Texas Gulf Sulphur Co.*;[67] the total impact of the defects in the *BarChris*[68] prospectus; the highly significant dividend cut in *In re Cady, Roberts & Co.*;[69] and the very substantial difference between the public market price and the price paid for the stock in *Affiliated Ute Citizens v. United States.*[70] Regardless of the verbal formulations used in those cases, there can, I think, be little quibbling about the essential nature of these facts.

However, the formulations—and sometimes the results—in some recent cases have greatly expanded the concept of materiality. In *Feit v. Leasco*,[71] Judge Weinstein observed that there is "a trend toward broadening the definition of materiality and concomitantly raising the requirement of disclosure where the law requires full disclosure."[72] He noted that the formulation in Second Circuit decisions has moved from whether a reasonable man *would* have been influenced to act differently to whether a reasonable man *might well* have acted otherwise.[73] The Supreme Court's formulations in *Mills v. Electric Auto-Lite Co.*[74] and *Affiliated Ute Citizens*[75] have been that a reasonable investor "might have considered" the facts important. In *Feit v. Leasco*[76] Judge Weinstein held that a fact is material "when it is more probable than not that a significant number of traders would have wanted to know it before deciding to deal in the security at the time and price in question."[77] He then stated that

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65 73 F. Supp. 798 (E.D. Pa. 1947).
66 99 F. Supp. 808 (D. Del. 1951).
67 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).
68 Escott v. BarChris Construction Co., 283 F. Supp. 643 (S.D.N.Y. 1968).
69 40 S.E.C. 907 (1961).
70 406 U.S. 128 (1972).
71 Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971).
72 *Id.* at 571 (citations omitted).
73 *Id.* at 569-70.
74 396 U.S. 375, 384 (1970).
75 406 U.S. at 153-54.
76 *See* note 71 *supra.*
77 332 F. Supp. at 571.

> [W]hat is statistically significant will vary with the legal situation . . . . Being a formal and legally required document, a prospectus must satisfy a high standard of disclosure—*i.e.*, disclosure is required when only a relatively small percentage of traders, would want to know before making a decision. Anything in the order of 10% of either the number of potential traders or those potentially making 10% of the volume of sales would seem to more than suffice.[78]

This is not far removed from Judge Waterman's statement in *Texas Gulf Sulphur*[79] that "[t]he speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders."[80]

The Second Circuit's opinion in *Chasins v. Smith, Barney & Co.*[81] is an example of a decison badly stretching the materiality concept. The plaintiff, acting upon Smith, Barney's recommendation, purchased four securities from Smith, Barney. Smith, Barney executed and confirmed as dealer, but failed to disclose that it was one of several market makers in the securities. Smith, Barney offered to prove that plaintiff purchased at the lowest possible price. The Second Circuit, agreeing with the district court's holding that Smith, Barney's failure to disclose its market maker status was an omission of a material fact in violation of rule 10b-5, affirmed the lower court's judgment for $18,000 in "damages," the difference between the purchase price and the price at which the plaintiff later sold the securities. Judge Friendly's dissent emphasized the minimal dangers and the probable advantage in dealing with a market maker and argued that Smith, Barney was at least entitled to a new trial on the issues of materiality and reliance. The majority opinion, however, stating the materiality test to be "whether a reasonable man in [the plaintiff's] position might well have acted otherwise than to purchase . . ."[82] if the disclosure had been made, found the omission material.

The expansion of "material facts" has, I believe, proceeded to the point at which counsel has minimal assurance that exclusion of any nontrivial information from the disclosure process is satisfactory because of the material fact limitation. Counsel's burden in stating that he knows of no material half-truth or omission is, therefore, broad-ranging and indeterminate, especially since both counsel will have performed considerable investigation and since company counsel may have acted as general counsel for years.

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78 *Id.*

79 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

80 401 F.2d at 849.

81 438 F.2d 1167 (2d Cir. 1971).

82 *Id.* at 1171.

C. *Who Are Corporate Counsel's Clients?*

Ethical Consideration 5-18 of the American Bar Association's Code of Professional Responsibility attempts to establish a strict entity theory for the corporation's counsel:

> A lawyer employed or retained by a corporation . . . owes his allegiance to the entity and not to a stockholder, director, officer, employee . . . or other person connected with the entity. In advising the entity, a lawyer should keep paramount its interests and his professional judgment should not be influenced by the personal desires of any person or organization. Occasionally a lawyer for an entity is requested by a stockholder, director, officer, employee, representatives, or other person connected with the entity to represent him in an individual capacity; in such case the lawyer may serve the individual only if the lawyer is convinced that different interests are not present.

Opinion 202 of the ABA's Committee on Legal Ethics,[83] issued in 1940, designated the board of directors as the ultimate embodiment of the corporate entity. An attorney retained by a corporation learned of questionable activities by its officers and was convinced that the officers would not fully report to the board of directors. The committee held that the attorney should disclose to the board of directors as it is the corporation's "governing body." This disclosure was found to be consistent with the canon requiring preservation of client confidences because the disclosure would be "to the client itself and not to a third person." Although the issue was not explicitly raised, I think it informative that the committee did not discuss the possibility of disclosure to the shareholders. Counsel retained by corporations have not considered shareholders to be their clients, although shareholders are the ultimate owners of the corporate assets and indirectly pay counsel's bills. That traditional view must be reexamined in light of the Fifth Circuit's 1970 decision in *Garner v. Wolfinbarger*.[84]

In *Garner* shareholders who had purchased stock from the corporation sued the corporation and its officers in a class and derivative action. The complaint alleged violations of the registration and antifraud sections of the securities statutes. The shareholders attempted to discover communications between the corporation's retained counsel and the corporation and its officers. The corporation asserted the attorney-client privilege. The district court, in what was apparently the first reported American case on the subject, held the privilege unavailable against the stockholders as plaintiffs.

The Fifth Circuit held that, where good cause is shown, the privilege

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[83] AMER. BAR ASSOC., OPINIONS ON PROFESSIONAL ETHICS 486 (1967).

[84] Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971).

cannot be asserted by a corporation in litigation between it and its shareholders if the latter are charging the corporation and its officers with acts injurious to shareholder interests. The court listed several factors to be considered in determining whether good cause exists. The list and the opinion seem heavily weighted toward an affirmative answer in most cases if shareholders show a colorable claim, good faith and are seeking to discover advice which related to prospective transactions. After the Fifth Circuit remanded, the lower court found good cause present.[85]

The Fifth Circuit's decision built upon, but proceeded well beyond, two traditional exceptions to the attorney-client privilege. The first is alleged communications in contemplation of a crime or fraud. The second is of more interest here. The court's analysis of the position of counsel to a corporation led it to conclude that counsel is a type of joint attorney —both the corporation and its shareholders are his clients.

Like most decisions creating law sharply departing from prior practices, *Garner v. Wolfinbarger* produces numerous uncertainties. For example, one of the court's footnotes states in what apparently is dictum:

> We do not consider it determinative whether the attorney consulted is corporate or house counsel or whether his fees are paid for by . . . management on its own account.[86]

There is little quarrel with the identical treatment of house counsel and outside counsel paid by the corporation, for one of the court's more telling observations was that "management is not managing for itself." But if management retains its own counsel and pays the fees for advice to management alone, there appears to be a clear absence of the shareholders as clients and every reason to uphold the privilege, absent a communication in contemplation of fraud or a crime. Indeed, one of the predictable results of *Garner* and the increasing emphasis upon the duties of corporate counsel to investors will be an increase in arm's length dealing between counsel and management in those few areas in which the interests of management and investors diverge or appear to do so, and there will be instances when management will be well advised to retain and pay for its own counsel to advise it alone.

The opinion does not specify whether the suing shareholders must have been such at the time of the communications between counsel and the corporation in order to effect discovery. A common counsel analysis suffers in persuasiveness when the communications precede the time the shareholder obtained his stock. As I read the opinions in *Garner v. Wolfinbarger*, however, the shareholders were attempting to reach communications relating to the offerings in which they became shareholders. Allowing shareholder status to relate back to the commencement of the plans for the of-

85 Garner v. Wolfinbarger, 56 F.R.D. 499 (S.D. Ala. 1972).

86 430 F.2d 1102 n.18.

fering is, of course, no stranger to the law: this legal fiction was the key to Judge Rugg's promoters' liability opinions in the *Old Dominion* cases.[87] Moreover, the portion of the Fifth Circuit's opinion dealing with the crime-fraud exception declared that "management has an obligation to the corporation, to the stockholders *and to the public* to do what is lawful."[88]

It is also unclear how *Garner v. Wolfinbarger* interacts with the injunctions in Canon 5 of the Code of Professional Responsibility regulating conflicts of interest. Preconditions to representation of multiple clients are: (1) that the attorney can obviously represent the interests of each; and (2) consent by each after full disclosure of the possible effects of the multiple representation on the exercise of the lawyer's independent professional judgment on behalf of each.[89] I doubt that the court was intimating that shareholders should participate in the selection of corporate counsel, or that it would be proper, even after disclosure and consent, for corporate counsel to represent the entity and prospective shareholders when the conflict is great—say, in negotiating the terms of a new stock issue. These were, of course, questions not before the court. The question before the court was whether counsel represented multiple clients, which the court answered in the affirmative. In any event, the long range interests of all parties in securities transactions—the corporate entity (including officers and directors), pre-existing shareholders, creditors, underwriters, and public purchasers—are fairly congruent in terms of compliance with the securities laws, because lawful disclosure documents and avoiding reliance upon unavailable exemptions from registration prevent liability and preserve contractual arrangements agreed upon after fair disclosure.

The American Bar Association, as amicus curiae, had argued that maximum compliance with the law would be the result of upholding the privilege. The Fifth Circuit's opinion summarized the ABA's position:

> The ABA urges that the privilege is most necessary where the corporation has sought advice about a prospective transaction, where counsel in good faith has stated his opinion that it is not lawful, but the corporation has proceeded in total or partial disregard of counsel's advice. The ABA urges that the cause of justice requires that counsel be free to state his opinion as fully and forthrightly as possible without fear of later disclosure to persons who might attack the transaction, and that without the cloak of the privilege counsel may be required by the threat of future discovery to hedge or soften their opinion.[90]

The court was unpersuaded:

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[87] Old Dominion Copper Mining and Smelting Co. v. Bigelow, 203 Mass. 159, 186-93, 89 N.E. 193, 205-08 (1909); Old Dominion Copper Mining and Smelting Co. v. Bigelow, 188 Mass. 315, 74 N.E. 653 (1905).

[88] 430 F.2d at 1103 (emphasis supplied).

[89] ABA CODE OF PROFESSIONAL RESPONSIBILITY, DISCIPLINARY RULE 5-105(B).

[90] 430 F.2d at 1102.

> However, we reject the idea that the prospective decision of the client on whether to abide by advice or disregard it, or the guarantee of a veil of secrecy, either establishes or narrows the attorney's obligation in the giving of advice. And to grant to corporate management plenary assurance of secrecy for opinions received is to encourage it to disregard with impunity the advice sought.[91]

Garner v. Wolfinbarger does not, I believe, answer a separate set of questions that may arise when shareholders sue the corporation and its management. The trend of the decisions in derivative actions in which the corporation is a nominal defendant and the actual defendants are management is to require new independent counsel for the corporate entity and to allow the corporate counsel to represent management.[92] This has been justified on the ground that corporate counsel is in fact closely allied with management and on the additional ground that counsel should defend his own work and advice when it is attacked.[93] If, however, counsel has indeed been a counsel for shareholders, is it proper for him to appear on behalf of management? The courts should be slow to use *Garner's* reasoning concerning the attorney-client privilege to disqualify corporate counsel from representing management in a derivative action or to represent the corporation and management in a class action against them if management has acted upon counsel's advice.

Two recent cases have held that corporate counsel cannot later bring a derivative action against his former client.[94] The opinions rely upon the concept of attorney-client confidences and implicitly exclude the shareholders as clients. The concept that a lawyer should defend his work will probably allow corporate counsel to represent management in derivative actions and the corporation and management in class actions when there is an attack on his advice. This area will be highly troubled, however. If the attorney has potential liability to the corporation, the conflict between counsel and the corporate entity in a class action could easily preclude representation. The central thought, however, is that identification of shareholders as clients for purposes of the attorney-client privilege should not be imported uncritically into motions for disqualification from representation. The ultimate justification for the holding in *Garner v. Wolfinbarger* is that a significant modification of the attorney-client privilege in litigation between the corporation and shareholders maximizes the probability that counsel's injunctions against activities he opines are wrongful will be fol-

91 *Id.*

92 *See* N. LATTIN, R. JENNINGS, & R. BUXBAUM, CASES AND MATERIALS ON CORPORATIONS, 871-72 (4th ed. 1968).

93 *See* Lewis v. Shaffer Stores Co., 218 F. Supp. 238 (S.D.N.Y. 1963); *cf.* Marco v. Dulles, 169 F. Supp. 622 (S.D.N.Y.), *appeal dism'd,* 268 F.2d 192 (2d Cir. 1959).

94 Richardson v. Hamilton Int'l Corp., [1972-1793 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,675 (3d Cir. 1972); Doe v. A Corp., 330 F. Supp. 1352 (S.D.N.Y. 1971); *but cf.* Rubin v. Katz, 347 F. Supp. 322 (E.D. Pa. 1972), *and* Federal Savings and Loan Ins. Corp. v. Fielding, 343 F. Supp. 537 (D. Nev. 1972).

lowed because a failure to follow the advice can be discovered and used to establish the most severe civil liabilities against management. If management follows counsel's advice to the effect that a transaction is proper, the newly discovered client relationship with shareholders should not disqualify counsel when he defends those who relied upon that advice.

In addition to increasing management compliance with counsel's securities advice, *Garner* may also expand the classes of persons to whom the attorney's professional duties run. By creating privity between corporate counsel and shareholders and incipient shareholders for purposes of the attorney-client privilege, *Garner* may provide the impetus for a similar analysis of the attorney's duties in giving securities advice. For example, in sales of stock by the corporation, counsel would find himself characterized as representing clients with conflicting interests and subject to the high duties of disclosure and fair dealing which accompany that status.[95] The increased duties to shareholders in the disclosure work undertaken by an attorney are obvious; being a counsel to the situation is demanding. There is nothing implausible in this analysis. By representing the issuer and yet giving a detailed opinion to underwriters, counsel places himself in much the same status vis-à-vis disclosure documents.[96] He is in privity with both the issuer and the underwriters and owes duties, admittedly somewhat ambiguous, to both in the disclosure process.

The duties of care concerning disclosure that counsel owes to the corporate entity may also directly flow to shareholders and prospective purchasers.[97] Until now, cases holding lawyers liable for their negligence to persons other than their clients and the addressees of their opinions have not been common.[98] If shareholders and prospective shareholders are clients along with the corporate entity, the privity citadel may be bypassed.[99] In the immediately following section, I shall discuss two areas in which such an analysis would raise especially perplexing questions for corporate counsel.

D. *Uncertainties Concerning Subsequent Developments and Subsequent Discovery of Earlier Disclosure Deficiencies*

Recent decisions have created strong pressures to bring to investors' attention the subsequent discovery of major defects in earlier disclosure

[95] *Cf.* R. KEETON, INSURANCE LAW § 7.7 (1971).

[96] *See* note 30 *supra* and accompanying text.

[97] This question was not before the court in Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971). The extrapolation from the holding in that case may be inviting, however.

[98] For a discussion of exceptions to this principle in California, *see* Lathrop & Rinehart, *supra* note 20, at 462-70.

[99] Indeed, the joint client analysis in Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971) will, I believe, be the theory used to bypass the privity limitations.

documents and subsequent developments materially concerning earlier disclosures on which investors are still relying. These problems are difficult enough when the attorney advises the client on its course of action. They become painfully perplexing when the attorney must determine his own independent obligations, and especially if shareholders as well as the corporation are his clients. Let me first generally review the authorities on subsequent discoveries of error and subsequent developments and then speculate about the attorney's independent obligations.

The allegations ruled on in *Fischer v. Kletz*,[100] the leading case, were that subsequent to the release of its certificate an accounting firm discovered that the figures in the company's annual report were substantially false and misleading, but did not timely inform the SEC, shareholders, or the trading market. The plaintiff alleged damages because of trading market purchases in reliance upon annual report figures. The court held that causes of action against the accountants were alleged under common law principles and rule 10b-5. The theory of the allegations was not aiding or abetting an alleged violation by the company,[101] but the more direct one, that the accountants failed to discharge their own duty to shareholders and prospective shareholders. Late in 1969 the AICPA issued Statement on Auditing Procedure No. 41, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, treating this issue as circumspectly as possible. On a prospective basis, the Statement appears largely to codify *Fischer v. Kletz*, but the AICPA asserted that the Statement "establishes procedures which go beyond current practice and . . . is not intended to be retroactive."[102]

Some of the cases discussed in *Fischer* concerned a related issue—whether one who has made a statement on which he knows others to be relying must disclose a *change* or *subsequent event* necessary to keep the earlier statement from being materially misleading. Considerable authority answers affirmatively, and *Fischer* relied upon that authority to hold as it did concerning the subsequent discovery of a fact existing but unknown at the time of the earlier statement.[103]

The AICPA's Statement on Auditing Procedure No. 47, *Subsequent Events*,[104] is a careful, effective warning to accountants of subsequent-events problems and, perhaps more importantly, attempts to establish a low level of duty to discover subsequent events bearing upon statements certified

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100 266 F. Supp. 180 (S.D.N.Y. 1967).

101 Concerning aiding and abetting, see Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972) [hereinafter referred to as Ruder].

102 AICPA, STATEMENT ON AUDITING PROCEDURE NO. 41, SUBSEQUENT DISCOVERY OF FACTS EXISTING AT THE DATE OF THE AUDITOR'S REPORT (1969).

103 In addition to the cases cited in Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967), *see* Equitable Life Ins. Co. of Iowa v. Halsey, Stuart & Co., 312 U.S. 410 (1941).

104 AICPA, STATEMENT ON AUDITING PROCEDURE NO. 47, SUBSEQUENT EVENTS (1971).

earlier. When the law requires reissuance of the statements at a later date —most importantly, when used in a later Securities Act prospectus—the Statement attempts to codify a very manageable level of investigation for accountants.

Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.[105] demonstrates the importance of the proper disclosure of updating facts and the conflicting pressures which the securities laws place upon management. According to the allegations, in the early part of 1966, McDonnell Douglas had publicly predicted substantial earnings for the first half of the fiscal year. On June 7 it issued a preliminary prospectus showing earnings for the first five months of 1966 of 85 cents per share. The plaintiff purchased 80,000 shares on the open market on June 22 and June 23. On June 24 McDonnell Douglas announced that its earnings for the first half of the year would be 12 cents per share, and plaintiff sold its stock during the next two weeks at a loss of about $2 million.

Plaintiff apparently did not allege specific reliance upon the public announcements or the preliminary prospectus, but rather was alleging that the market had been affected by them. Plaintiff claimed that the announcement should have been issued several days before it was. The district judge refused to set aside the jury's $700,000 verdict for plaintiff, but the Tenth Circuit reversed in a confusing opinion and ordered judgment entered for the defendant. The decision can be read as holding that the disclosure of a new development to the trading markets is a matter entrusted to the business judgment of management. However, a more plausible reading, and one that would make the most sense out of the opinion, is that the defendant's management exercised reasonable care and dispatch in pursuing the first indications of trouble in late May and making the announcement of reduced earnings only after a careful study of the extent of the problem. *Texas Gulf Sulphur*[106] requires reasonable care in the preparation of press releases, and management should not be faulted for taking the time to investigate and verify before an announcement is made.

The Second Circuit's decision in *SEC v. Manor Nursing Centers, Inc.*[107] has firmly upheld an updating requirement. The court held that in a Securities Act registration, a material development *after* the effective date but during the distribution period should be reflected by a sticker amendment or by supplementary material delivered with the prospectus in order to avoid violation of § 17(a) of the Securities Act and rule 10b-5. In-

105 CCH FED. SEC. L. REP. ¶ 93,773 (10th Cir. 1973), *rev'g* [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,004. For other earlier opinions below, see [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,811; [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,760.

106 SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

107 458 F.2d 1082 (2d Cir. 1972).

deed, the court even accepted the SEC's argument that a failure to reflect such changes would cause the use of the unchanged prospectus to run afoul of § 5. This latter holding seems wrong (§§ 11, 12(2), and 17(a) of the Securities Act and rule 10b-5—and *not* §§ 5 and 12(1)—seem designed for the defective prospectus filed with the SEC and allowed to become or remain effective) but it does illustrate the court's eagerness to encourage updating of the prospectus during the distribution period.

In its recent decision in *In re Butcher and Sherrard*,[108] the SEC held that a broker-dealer violates the antifraud rules by communicating a change in the firm's recommendation concerning a stock to only a preferred group of customers.

Rule 14a-9, the antifraud provision of the proxy rules, prohibits solicitation—

> which *omits* to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which *has become* false or misleading.[109]

This tells us that if there is more than one volley of soliciting material, each must update that material in earlier solicitations which has become false or misleading. It does not state, however, whether there is a duty to correct earlier material which has become misleading since the *final* solicitation.[110] As we have seen, this ambiguity could become a major issue in the *National Student Marketing* litigation.[111]

The "K" reports and proxy statements under the Exchange Act are not designed to continuously update all of the company's Exchange Act or Securities Act registration statement. Rather, the "K" reports and proxy statements need cover only the enumerated, limited items plus enough additional information to prevent that given from being misleading. The result of this is that no universal updating requirement is found in either the "K" reports or the proxy rules. In contrast, information in broker-dealer registration forms must constantly be amended to reflect subsequent events.[112]

The most widely applicable provision is rule 10b-5. Especially since *Texas Gulf Sulphur*,[113] everyone now recognizes that when the company

108 CCH FED. SEC. L. REP. ¶ 79,135 (SEC 1972). The opinion was issued pursuant to an offer of settlement submitted without admitting or denying the allegations in the order for proceedings.

109 17 C.F.R. § 240.14a-9 (1972) (emphasis supplied).

110 Note, however, that there may be oral solicitations after the final written one. Those oral solicitations appear to be subject to the updating requirement.

For an expansive view of the updating requirements in rule 14a-9, *see* Gould v. American Hawaiian Steamship Co., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,682 (D. Del. 1972).

111 *See* text accompanying notes 9-11 *supra*.

112 *See* 17 C.F.R. § 240.15b3-1(b) (1972).

113 *See* cases cited note 106 *supra*.

does issue a press release or report to shareholders, reasonable care must be exercised to prepare a document free of material misstatements or half-truths, and that if a material development has not been disclosed to the markets, insiders and the company must refrain from taking advantage of the hiatus in information. Furthermore, the SEC has recently adopted a specific rule under § 10(b) of the Exchange Act[114] requiring appropriate advance disclosure to the trading markets of dividend payments,[115] and I believe § 10(b) clearly would authorize a rule requiring prompt disclosure to the trading markets of all material developments.[116] At present, however, it is unclear what duties of affirmative disclosure of material developments to the trading markets are imposed by rule 10b-5. The SEC has not helped by cryptically declaring that issuance of routine quarterly reports may be misleading without disclosure of other developments.[117]

My point, however, is different. Discussion of a possible rule 10b-5 duty of affirmative disclosure of material developments to the trading markets has tended to focus on the development without considering their relation to earlier disclosures. Considering reports to shareholders, speeches to analysts, press releases, "K" reports and Securities Act registration statements, a company with a trading market has, at any point in time, fed vast amounts of information into the market within the fairly recent past. Rarely will a material development occurring since the last public disclosure *not* have a logical nexus with several items of the earlier information. Furthermore this is widely recognized in connection with merger negotiations, lawsuits and earnings projections: everyone quickly announces material changes from the earlier announced status in these areas. The principle seems broader, however. Suppose an annual report discussed highly material new contracts, but three months later significant serious interpretational disputes with the other party arise. Counsel and the company's executives recognize a considerable possibility of litigation and that a judicial determination adverse to the company is also a real possibility. Does rule 10b-5 require prompt disclosure of the dispute for the benefit of the trading markets?

Fischer, the leading disclosure case, involved an accountant's certificate. Lawyers have assumed that the duties and liabilities of accountants and lawyers in the disclosure process are fundamentally different. Accountants, it is said, undertake a public duty. Lawyers are thought, however, to

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114 Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1970).

115 17 C.F.R. § 240.10b-17 (1972).

116 *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971): "Section 10(b) must be read flexibly, not technically and restrictively." *Cf.* Sommer, *The Annual Report: A Prime Disclosure Document*, 1972 DUKE L.J. 1093.

117 SEC Exchange Act Release No. 5092 (Oct. 15, 1970), discussed in Dayan, *Correcting Errors in the Press*, REVIEW OF SECURITIES REGULATION, 941-45 (April 6, 1972) (good treatment of correction and updating requirements).

be advisers to and advocates for the issuer.[118] *Garner* may lead to the demise of the distinction.

Consider, for example, the situation in which counsel to a publicly owned issuer opined to underwriters that he knew of no material misstatements or omissions in a prospectus. A few weeks later counsel discovers a material omission in the narrative material. The prospectus is affecting the trading markets. I see little policy reason for distinguishing between counsel's position in this situation and the position of the accountant who later discovers a material missstatement in the audited financials. Though the issuer's counsel does not agree to make a reasonable investigation of the narrative portion of the prospectus, had he known of the material omitted fact during the preparation process he would have insisted upon inclusion—and would have had his way, for no major securities transaction will close in the absence of an opinion that the issuer's counsel knows of no material misstatement or omission in the disclosure documents. There is obviously a difference in the initial duty of the accountant and the attorney in terms of the factual investigation, but once there is knowledge of a material defect in the portion of the disclosure document passed upon by them, it seems artificial and decidedly contrary to the purposes of the securities laws to treat the attorney differently from the accountant. Conceiving of the lawyer as counsel to shareholders and prospective shareholders for purposes of determining his duties to the trading markets is, therefore, a distinct possibility.

If the corporation's counsel is thought to represent the corporation and its present and prospective shareholders, he may also have an independent duty to the trading markets to ensure that his knowledge of subsequent major developments affecting earlier disclosure documents prepared by him be disclosed, assuming the earlier disclosures still affect the trading markets. This precise question will, however, seldom arise. Counsel's advice to the corporation will invariably be to disclose the subsequent development in order to prevent liability, and management will normally have every inducement to follow the advice. A subsequent development usually will imply no defect in the earlier disclosure, so that disclosure of the subsequent development can most often only prevent liability and not generate it.

There may, however, be more resistance by counsel and management to the disclosure of a subsequently discovered material error in an earlier disclosure document. Counsel may make the discovery in the course of his continuing representation of the corporation, and the error may raise questions of counsel's liability. A public confession of error is not a delight. If the error was in a Securities Act registration statement and the statute of limitations has not run at the time of discovery, announcement

118 For strong positions to this effect, see Karmel *supra* note 26, and Freeman, *supra* note 26.

of the error may invite liability, for even reasonable care and reliance upon experts are not defenses for the issuer under § 11. On the other hand, if the trading markets are still relying upon the disclosure document, concealment is probably a fraud by the corporation, management,[119] and the attorney. Furthermore, issuance of subsequent financials and other disclosure documents without revealing the contingent liability created by the known material error may violate the antifraud rules. The statutes of limitations may also be tolled during the concealment. In short, even the most pragmatic calculas may point to disclosure.

Suppose, however, that there is no possibility of a trading market and little possibility of reliance by those who purchase from the initial purchasers on the disclosure document in which there is a subsequently discovered major error. A private offering of the stock of a newly formed corporation pursuant to an informal offering circular delivered to the purchasers before closing and relied upon by them supplies an excellent example. Suppose the purchasers required the opinion of counsel to the corporation as a condition of closing, and that his opinion contained the customary language that to counsel's knowledge there was no material omission or half-truth in the offering circular. Though counsel actually knew of no such defects when his opinion was delivered, he discovered one two months later and reported it to management (the promoters). It is, let us assume, clear that the purchasers would have a good cause of action under § 12(2) of the Securities Act. *Fischer v. Kletz* is not directly relevant here, for in that case the plaintiffs were trading market purchasers who had acquired their stock *after* the alleged discovery of the earlier error. This is the most difficult possible question concerning the corporation's obligation to disclose a subsequently discovered error. For counsel, the question of his independent duty to disclose is excruciating. His opinion at closing was addressed to the purchasers and if he had known then what he now knows, either his opinion would not have issued or, more likely the disclosure would have appeared in the offering circular and the price would have differed or the deal would have folded. If the purchasers are his clients along with the corporation, he may have an independent duty to alert the purchasers so they can assert their rights.[120]

E. *Uncertainties Concerning the Requirements Imposed by the Antifraud Provisions upon Attorneys for Factual and Legal Certainty*

1. The Antifraud Provisions

As noted above, the securities statutes seldom deal explicitly with the

[119] *Cf.* Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

[120] *Cf.* R. KEETON, INSURANCE LAW 494-95 n.9 (1971). *See also* text accompanying notes 147-49, 165-66 *infra*.

duties of lawyers. Section 11 of the Securities Act, which creates express liabilities for deficient registration statements, sometimes applies to attorneys' opinions, but only to those few opinions that are referred to in the prospectus and as to which the attorney files a consent to use. When the attorney is subject to § 11, he probably must use reasonable care in ascertaining the facts on which his opinion is based as well as in ascertaining and applying the law; his duties run to all purchasers, whether or not in privity with him.

Section 12 of the Securities Act creates two express remedies. Section 12(1) applies when there is noncompliance with the registration requirements of § 5; due care defenses are apparently not available if § 5 is in fact violated. Section 12(2) is an antifraud provision applicable to material misstatements of fact or half-truths in the sale of any security, registered or unregistered; no liability attaches if the defendant shows "that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."[121] The express remedies under § 12 of the Securities Act have seldom been applied in connection with persons acting as attorneys because § 12 reaches only defendants who offer or sell a security; as stated in *Wonneman v. Stratford Securities Co.*[122]: "The defendant must be, for example, the actual seller or one who negotiated the sale; the owner of the securities sold or a person who in some manner controls the seller."[123] In *Wonneman*, the attorney did the legal work incident to reviving a dormant corporation and revamping it so that its shares could be sold publicly. The actual sales were induced by the attorney's erroneous oral opinion to a seller that the securities were exempt from registration. Although the court found that the sales violated § 5, the attorney was held beyond the ambit of § 12(1).[124]

Judge Friendly's opinion in *Katz v. Amos Treat & Co.*[125] demonstrates that an attorney who solicits is within § 12. There, a person acting as attorney for the issuer as well as for a broker-dealer promoting an unregistered offering of the issuer's stock was among the defendants in a § 12(1) action. Evidence warranted a possible inference that the attorney "had not simply answered [the investor's] questions but had placed [the broker-dealer] in a position to tackle [the investor] for the money."[126] The court thus reversed the district judge's action in dismissing the complaint against the attorney at the close of plaintiff's case, holding that "a jury could properly decide that [the attorney] had been a party to a solici-

121 Securities Act § 12(2), 15 U.S.C. § 77*l*(2) (1970).

122 [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,034 (S.D.N.Y. 1961).

123 *Id.* at p. 93,459.

124 There was apparently no rule 10b-5 allegation in this case.

125 411 F.2d 1046 (2d Cir. 1969).

126 *Id.* at 1053.

tation."[127] *Katz* raises the question whether a lawyer who drafts a disclosure document is a party to a "solicitation" for purposes of §§ 12(1) and 12(2). If § 12(2) is triggered, is the document drafted by counsel "his" statement so that if there is a material omission or half-truth, he must prove "that, he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission"?[128] I suspect that the answer to this is that a disclosure document drafted by an attorney for use by a client and issued under the client's name is the client's solicitation, and not the attorney's, for purposes of § 12. *Katz* is distinguishable in that the attorney allegedly went beyond a pure attorney's function and tried to sell the securities. Attorneys often do this, and their § 12 exposure is large for that reason. I doubt, however, that the purely professional functions of rendering legal opinions and drafting disclosure documents for use by clients are covered by § 12.

The discussion in the remainder of this section is restricted to the antifraud rules, primarily rule 10b-5. Those rules are the proscriptions most directly applicable to attorneys because there is no privity requirement (the proscribed act need only be in connection with any purchase or sale by any person), because all securities transactions are reached by those rules, and because the proscriptions of fraud and material misstatements and half-truths in the rules obviously are pertinent to attorneys' advice and opinion-giving functions. I will also place to one side the lawyer's obligations as a controlling person because the lawyer will most often not be a controlling person and because even when he is, his pivotal role in securities transactions should cast upon him direct duties under the antifraud rules that are at least as demanding as those of a controlling person.

As discussed earlier, attorneys draft or place in final form the narrative portion of most disclosure documents. They are expected by their clients to perform considerable factual investigation, though how much is unspecified. At the same time they have attempted to limit their responsibility for factual accuracy and completeness. When lawyers opine on exemptions from registration, another technique for attempting to avoid entanglement in factual investigation is often adopted: the client will supply facts, the opinion letter will recite the version of the facts that has been supplied and the source (thus negating independent verification by the attorney), and the favorable opinion will be expressly based upon those facts. As we have noted, securities opinions, even on close questions, are usually issued "clean" or not at all; probability assessments are seldom included. These practices create nice questions under state law concerning the lawyer's exposure to clients whenever there is a material factual deficiency or courts

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127 *Id.*

128 This is the language of the due care defense in Securities Act § 12(2), 15 U.S.C. § 77*l*(2) (1970).

disagree with the attorney's legal conclusion. These same questions, in slightly altered form, arise again under the antifraud rules.

In light of the attorney's pivotal position in securities regulation, it seems strange that 40 years after the enactment of the two key federal statutes, the Securities Act and the Exchange Act, only a few SEC releases and judicial opinions discuss the duties of factual investigation which the antifraud rules impose upon counsel. There is even less authority on a related question—the certainty on the law needed before a clean, favorable opinion should properly emerge. This paucity of authority can be attributed primarily to the reluctance of attorneys to sue or blame their brothers, a reluctance which SEC attorneys seem to be shedding and which may diminish even more sharply if a specialized plaintiffs securities litigation bar develops and the realization spreads that large law firms and their liability policies often represent the deepest available pocket.

2. Factual Investigation and Inquiry Notice

In Securities Act Release No. 4445, *Distribution by Broker-Dealers of Unregistered Securities*, issued in 1962, the SEC touched upon its views of the obligation of counsel to investigate underlying facts before opining:

> There have been a number of cases in which dealers have unsuccessfully sought to justify a claim to exemption under Section 4(1) of the Securities Act simply by securing from the sellers, actual or ostensible, representations that such persons are neither officers, directors, nor large stockholders of the issuer, and submitting such representations to an attorney who then gives an opinion to the effect that, assuming the correctness of such representations, exemption under Section 4(1) is available. Obviously an attorney's opinion based upon hypothetical facts is worthless if the facts are not as specified, or if unspecified but vital facts are not considered. Because of this, it is the practice of responsible counsel not to furnish an opinion concerning the availability of an exemption from registration under the Securities Act for a contemplated distribution unless such counsel have themselves carefully examined all of the relevant circumstances and satisfied themselves, to the extent possible, that the contemplated transaction is, in fact, not a part of an unlawful distribution. Indeed, if an attorney furnishes an opinion based solely upon hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct.

The Release seems to condemn the described practice even for those situations in which the opinion letter states that the exemption holds only if the represented facts are true.[129] The Release implies that securities opinions which lack fact-vouching are rare. Opinions on material omissions and misstatements are always given in this form, however. Furthermore,

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[129] This indicates that counsel does not stand behind the represented facts, except perhaps for no knowledge of falsity.

counsels' opinions on exemptions often express reliance upon facts supplied by others.

The Release thus poses a serious issue, for the SEC seems to take the view here that it follows on an accounting method inconsistent with generally accepted accounting principles—that no amount of disclosure cures the defect.[130] The scope of the Release can, however, probably be interpreted in accordance with its terms as limited to opinions on exemptions. A lawyer's opinion that an exemption exists is crucial, for it is the passkey used to avoid registration with the SEC and that agency's opportunity to examine disclosure documents before a sale is made. At the same time, a reasonable investigation of the underlying facts preparatory to furnishing an opinion on an exemption is usually a much lighter burden than a reasonable investigation of the facts in a prospectus.

United States v. Simon[131] holds, by direct analogy, that counsel's lack of good faith belief in the correctness of facts or his legal conclusions could constitute criminal scienter and, a fortiori scienter and sufficient participation for civil liability under rule 10b-5. But is more than good faith required? For example, § 11 of the Securities Act establishes an "inquiry notice" standard for one relying upon an expert's statement. If the statement contains a material misstatement, omission or half-truth, persons other than the expert are excused from liability if they show that they "had no reasonable ground to believe and did not believe" that the deficiency existed. No "reasonable investigation" is required. This inquiry notice standard, which lies between good faith belief and reasonable belief after reasonable investigation (the usual standard under § 11), requires one to investigate possible defects concerning which he has been put on notice.

The standards imposed by the antifraud rules are discussed in the Second Circuit's 1968 decision in *SEC v. Frank*.[132] An offering circular used in an intrastate offering contained alleged inaccuracies in the description of a chemical additive produced by the company. The SEC obtained a temporary injunction against the company (by consent) and against the lawyer, Frank. The SEC alleged that Frank had actual knowledge of inaccuracies in the description of the additive. The injunction forbade Frank from drafting any statement containing material misstatements or half-truths about the additive. Frank appealed to the Second Circuit, maintaining that company officers had drafted the description and that his function had been that of a scrivener untutored in chemistry helping the officers to place their ideas in proper form. The following passage from

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[130] *See* L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 2.6-2.10 (3d ed. 1972).

[131] United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

[132] SEC v. Frank, 388 F.2d 486 (2d Cir. 1968).

Judge Friendly's opinion identifies the standards imposed by the antifraud rules and states the inquiry notice issue:

> Although Frank makes much of this being the first instance in which the Commission has obtained an injunction against an attorney for participation in the preparation of an allegedly misleading offering circular or prospectus, we find this unimpressive. As this court said in *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir.), cert denied, 377 U.S. 953, 84 S. Ct. 1631, 12 L. Ed. 2d 497 (1964), "In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or crowbar." A lawyer has no privilege to assist in circulating a statement with regard to securities which he knows to be false simply because his client has furnished it to him. At the other extreme it would be unreasonable to hold a lawyer who was putting his client's description of a chemical process into understandable English to be guilty of fraud simply because of his failure to detect discrepancies between their description and technical reports available to him in a physical sense but beyond his ability to understand. The instant case lies between these extremes. The SEC's position is that Frank had been furnished with information which even a non-expert would recognize as showing the falsity of many of the representations quoted in fn. 1, notably those implying extensive and satisfactory testing at factories and indicating that all had gone passing well at the test by the Army Laboratories. If this is so, the Commission would be entitled to prevail; a lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand. . . . Whether the fraud sections of the securities laws go beyond this and require a lawyer passing on an offering circular to run down possible infirmities in his client's story of which he has been put on notice, and if so what efforts are required of him, is a closer question on which it is important that the court be seized of the precise facts, including the extent, as the SEC claimed with respect to Frank, to which his role went beyond a lawyer's normal one. Compare Securities Act of 1933, § 11(a).[133]

The judgment below was reversed and remanded for further proceedings consistent with the Second Circuit's opinion.

In 1972, the SEC lost an interesting injunctive case against an attorney. In *SEC v. Spectrum, Ltd.*,[134] the SEC sought to tag an attorney, who had issued an allegedly erroneous favorable opinion on an exemption from registration under the Securities Act, with status as a statutory "underwriter" and an aider and abettor. The district court found against the SEC on both charges. The defendant was not an underwriter, said the court, since he had not sold securities and since there was no evidence that securities were sold on the basis of the alleged misrepresentations in his letter. The court noted that the SEC had no authority for the proposition "that the mere preparation of an opinion letter is sufficient to make the preparer an

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[133] *Id.* at 488-89.

[134] [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,631 (S.D.N.Y. 1972).

underwriter."[135] The defendant was absolved of aiding and abetting due to a lack of evidence that the attorney had knowledge of an improper scheme and had performed (or omitted to perform) acts necessary to the furtherance of the scheme. Of the defendant, the court said: "While he may have been guilty of some negligence in preparing the opinion letter, there is insufficient evidence to support anything more serious than that."[136]

I have found no other important decisions or SEC Releases on the issue of what factual investigations counsel must undertake. The recent consent injunction in *SEC v. Pig N'Whistle Corp.*[137] required an independent public relations firm reasonably to investigate facts supplied to it by the client before the firm disseminates public relations materials. Furthermore, broker-dealers and their salesmen must reasonably investigate before recommending a security.[138] When a lawyer drafts a disclosure document, which by definition is used in connection with securities transactions, his role is no less active than that of the public relations firm or the broker-dealer.

It appears anomalous, therefore, that counsel's duties toward facts are usually stated in much less demanding formulations than are the duties of other securities business professionals. On the other hand, since corporate counsel usually has a continued deep involvement in the corporation's activities, a duty to follow through under a standard of inquiry notice may be as or more demanding. For example, a reasonable investigation by an unaffiliated broker-dealer recommending a publicly traded security probably requires less probing than is required of corporate counsel in drafting an offering circular for use in an unregistered intrastate offering, because counsel may have inquiry notice of numerous material facts.

3. The Clean Opinion Problem

a. The problem

As discussed earlier, written opinions on securities transactions almost invariably issue with a flat legal conclusion. Purchase agreements probably contemplate unqualified opinions. Counsel presenting a written opinion that, in his judgment, there is an estimated .60 probability that an offering is exempt or supplying an opinion to underwriters that there is an estimated .70 probability that a fact omitted from the prospectus would be held

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[135] *Id.* at p. 92,867.

[136] *Id.* at p. 92,868.

[137] [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,384 (N.D. Ill. 1972). *See also* BNA SEC. L. REP. NO. 140, at G-2 (Feb. 14, 1972) (views of SEC concerning the consent injunction).

[138] *See* Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); R. JENNINGS & H. MARSH, JR., CASES AND MATERIALS ON SECURITIES REGULATION 821-26 (3d ed. 1972); Note, *Security Salesmen's Failure to Disclose Material Adverse Circimustances in Recommending Speculative Security Held to Violate Securties Acts*, 44 N.Y.U. L. REV. 1191 (1969).

immaterial, will probably introduce an unwanted and unacceptable marriage of law and statistics. The same unfavorable result—screams at the closing or perhaps no closing—may obtain if counsel attempts to convey by narrative description the same message.

We earlier explored the possibility that a laconic clean opinion on a puzzle may not be a good idea from the standpoint of counsel's liabilities to his clients and the recipients of the opinion. In a malpractice action against the attorney, initiated after the courts have offered a solution to the puzzle different from his, the client or recipient of the opinion may claim that a more sophisticated assessment by counsel would have led to a different, less unfavorable course of action. Again the possibility that *Garner*[139] may place corporate counsel in the position of counsel to the situation is pertinent. If corporate counsel is in effect counsel for both the corporate entity and purchasers, his status as a common counsel increases his duties of disclosure. No doubt some purchasers would like to know of significant possibilities that the deal in which they are participating will breed liabilities against the corporation in which they will be stockholders. Others, such as a broker-dealer participating in what it hopes is a private offering and desiring protection in the event of a broker-dealer disciplinary proceeding, would not be pleased to see counsel's opinion turn into a frank essay on imponderables.[140]

Lawyers can control this set of problems by abstractly specifying that on all points their favorable opinion means only that they are opining that the indicated result is more likely than not if the matter were to be litigated and that no attempt will be made to identify the estimated larger degree of certainty on any particular point. Lawyers assume, I believe, that their securities opinions on unsettled law are now so construed by everyone, but I do not believe that is at all clear, as is evidenced by the cautious, more explanatory approach taken when an attorney's opinion on a close point of law is referred to in the prospectus pursuant to counsel's filed consent.

b. *The standard under rule 10b-5*

Our inquiry here is a different one, however: Does counsel's failure to put a probability estimate in his opinion on a close question of law make the opinion a misleading document issued in connection with a securities transaction and thus a violation of rule 10b-5? *Texas Gulf Sulphur*[141] and *Feit v. Leasco*[142] have introduced highly general probability assess-

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139 *See* note 84 *supra* and text accompanying notes 95-96 *supra.*

140 *But cf.* note 193 *infra.*

141 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849-50 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

142 Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 570 (E.D.N.Y. 1971).

ments into the determination of whether a fact is material. The most analogous authority[143] suggests, however, that the general antifraud rules are not violated whenever a clean opinion issues upon counsel's reasonable belief that the indicated result is more likely than not and are probably not violated when counsel believes in good faith that the indicated result is more likely than not.

Ethical Consideration 7-4 of the Code of Professional Responsibility gives the litigator the widest possible latitude. The advocate may urge any permissible construction of the law and take a position supported by the law or "supportable by a good faith argument for an extension, modification or reversal of the law."[144] The only limitation is that his position be non-frivolous and that directly adverse legal authority known to counsel be disclosed if opposing counsel does not do so.[145] The Code, however, recognizing the distinction between advocate and adviser, cautions the attorney-adviser to advance the client's interests by "giving his professional opinion as to what he believes would likely be the ultimate decision of the courts on the matter at hand and by informing his client of the practical effect of such decision."[146] In giving this advice to a client, Disciplinary Rule 6-101 requires the lawyer to act competently.[147]

When, however, the Code focuses upon third parties' protection, it is less clear. Disciplinary Rule 7-102 forbids an attorney to "*knowingly* make a false statement of law or fact," or "counsel or assist his client in conduct . . . the lawyer knows to be illegal or fraudulent."[148] More demanding is Disciplinary Rule 1-102, which prohibits attorney conduct "involving dishonesty, fraud, deceit, or *misrepresentation*," and the limiting adverb "knowingly" is not found.[149] This arguably requires reasonable research of the law and a reasonable belief that the opined result is the most likely one.

In 1965, the ABA Committee on Professional Ethics issued Opinion 314[150] on an analogous question, whether an attorney must, when the law is unclear, advise a client to attach a rider to a tax return claiming a nonsegregated deduction or omitting a receipt from inclusion as income. The opinion states that

> [A] lawyer who is asked to advise his client in the course of the preparation of the client's tax returns may freely urge the statement of positions most favorable to the client just so long as there is a reasonable basis for these

143 *See* text accompanying notes 144-158 *infra.*

144 ABA CODE OF PROFESSIONAL RESPONSIBILITY, ETHICAL CONSIDERATION 7-4.

145 *Id.*, ETHICAL CONSIDERATION 7-23.

146 *Id.*, ETHICAL CONSIDERATION 7-5.

147 *Id.*, DISCIPLINARY RULE 6-101.

148 *Id.*, DISCIPLINARY RULE 7-102(A)(5), (7) (emphasis supplied).

149 *Id.*, DISCIPLINARY RULE 1-102(a)(4) (emphasis supplied).

150 AMER. BAR ASSOC., OPINIONS ON PROFESSIONAL ETHICS 688 (1967).

> positions. Thus where the lawyer believes there is a reasonable basis for a position that a particular transaction does not result in taxable income or that certain expenditures are deductible as expenses, the lawyer has no duty to advise that riders be attached to the client's tax return explaining the circumstances surrounding the transaction or the expenditures.[151]

Counsel surely has a reasonable basis for his opinion when he believes it more likely than not that the undisclosed exclusion or the unsegregated deduction would be allowed by the courts. "Reasonable basis," however, might mean only substantial grounds even if the Commissioner apparently has the better position.

There are good arguments, however, against the latter interpretation. By definition we are talking about items known by the lawyer to be questionable. Failure to flag the questionable items by a rider will often remove them from scrutiny by the Commissioner and the courts in an adversary proceeding. Substantial arguments falling below an estimated .50+ probability of success can usually be put together by ingenuity and manipulation, and in litigation such arguments would be forcefully advanced with some chance of success. When, however, the question is fair disclosure to the Commissioner, and hence making the self-assessment system work, a standard of "more likely than not" seems appropriate. This is especially true since attorneys' opinions provide great protection against penalties. That protection is not likely to continue if Congress and the courts feel that attorneys commonly issue, on weak grounds, opinions that nondisclosure is proper.

The case for the opposite conclusion, that only a substantial argument is needed for the lawyer to conclude that there is a reasonable basis, is forceful, however. The Treasury Department is armed with considerable authority to require riders by regulations.[152] In the absence of such regulations, why should the bar do the Treasury's job? If the bar attempts to push clients toward extensive use of riders without a legal mandate to do so, endless friction can result. Furthermore, only a semantic difference separates a standard contemplating substantial arguments and one requiring a judgment that success in court would be more likely than not. On an unsettled question of law, an attorney finding substantial arguments would, perhaps unconsciously, elevate them to an estimated .50+ probability of success in court if that is the judgment required for him to advise that nondisclosure is proper.

In *United States v. Benjamin*,[153] one of the factors on which the Second Circuit relied in affirming the criminal conviction of a lawyer for viola-

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[151] *Id.* at 691.

[152] *See, e.g.*, INT. REV. CODE OF 1954 §§ 6001, 6011(a); Bittker, *Professional Responsibility in the Preparation of Federal Income Tax Returns* in PROFESSIONAL RESPONSIBILITY IN FEDERAL TAX PRACTICE, 250-56 (B. Bittker ed. 1970).

[153] 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964).

tion of the securities statutes was his issuance of an opinion that an exemption was available "although he must have known"[154] that the facts of the situation negated the exemption. This indicates that a good faith belief in the correctness of an opinion, perhaps coupled with investigation of facts of which he has inquiry notice, would suffice to remove the attorney from the antifraud rules, at least in criminal actions. This standard would accord with other leading authorities on the application of criminal and regulatory statutes to counsel's advice-giving function.

In 1966, the Ninth Circuit spoke on counsel's liability in a private antitrust damage action charging attempted monopolization.[155] The court held in the negative where the only role is that of legal adviser (even if the legal advice is wrong). "But," said the court, "if he [counsel] goes beyond that role and, acting by himself or jointly with others, makes policy decisions for the corporation, then he subjects himself to liability for attempted monopolization as in the case of any executive officer of the company performing a similar function."[156] The court did not state that the immunity for legal advice is limited to advice given with good faith belief in its correctness, although that seems a fair implication of the lawyer-business policy dichotomy, for one lacking good faith belief in his advice that a course of conduct is legal is not acting as a lawyer.

One of the leading casebooks on Legal Profession has long carried *People v. Kresel*,[157] a New York Appellate Divison case holding that a lawyer giving good faith advice on a doubtful question of law that a course of action is legal does not become an aider and abettor simply because his advice is wrong. The lawyer had been convicted after a jury instruction that the only intent required was that required of a director (intent to do the prohibited act). In reversing, the majority opinion said:

> There is no evidence that appellant urged or incited anyone to commit any offense. The extent of his offending is that he failed to forbid his clients to proceed. He swore that he believed the plan to be within the law. The court of last resort has since held that he was mistaken. When appellant gave his advice, the question was unsettled. It is worthy of note that neither the Appellate Division nor the Court of Appeals was unanimous in its construction of the law. A lawyer is not to be held criminally responsible because he honestly gives mistaken advice upon a doubtful question of law. No lawyer is answerable if he is mistaken concerning a question of law on which reasonable doubt may be entertained by well-informed lawyers. . . . In Montriou v. Jefferys, 2 Carr. & P. 113, 116, Lord Chief Justice Abott said :"No attorney is bound to know all the law; God forbid

154 *Id.* at 863.

155 Tillamook Cheese & Dairy Ass'n v. Tillamook Co. Cream Assn., 358 F.2d 115 (9th Cir. 1966).

156 *Id.* at 118.

157 243 App. Div. 137, 277 N.Y.S. 168 (1935), reprinted in part in S. THURMAN, E. PHILLIPS, JR. & E. CHEATHAM, CASES AND MATERIALS ON THE LEGAL PROFESSION 246 (1970).

that it should be imagined that an attorney, or a counsel, or even a judge is bound to know all the law."

Infallibility is an attribute of neither lawyer nor judge. And yet in this case the trial court said to the jury that appellant was conclusively presumed to know the law and that the law involved herein was plain and unambiguous. It is a silly perversion of the legal fiction that every one is bound to know the law, to insist that, in this field of law, lawyers shall decide all questions in accordance with what the courts may ultimately hold, at the peril that the failure to prophesy correctly the final outcome will make them criminal accessories.[158]

c. The resolution

It would appear doubtful that the courts, in applying the antifraud rules, would hold an attorney to have violated those rules under a theory that, while he made a good faith attempt to apply the governing authorities to particular facts, his belief that he was correctly doing so was unreasonable. If the attorney's sole error is in synthesis, extrapolation, or projection, it is next to impossible to find fault with such an error. We have seen that these errors are usually beyond the realm of malpractice actions, much less actions under the antifraud rules.

The strong possibilities for application of the present antifraud rules to erroneous legal opinions rendered in subjective good faith arise, it seems to me, only when the attorney fails to follow through on factual discrepancies of which he has inquiry notice or when he has not reasonably researched the law. The courts will probably not exclude legal opinions, which unleash securities upon investors, from the antifraud rules unless the attorney has followed through on facts of which he has inquiry notice. It is a waste of the attorney's knowledge of the law to allow him to opine favorably on the basis that he has no actual knowledge of facts that would change his opinion. Of all the people involved in a securities transaction, the attorney is by far the most aware of the significance of facts of which he has inquiry notice. Indeed, this may be one of the reasons why the SEC seems to maintain that an attorney should not favorably opine on an exemption unless he has reasonably investigated the underlying facts.

Likewise, a failure reasonably to research the law before opining could negate the exemption from the antifraud rules for an erroneous opinion given in subjective good faith. The imposition of such a duty would be analogous to requiring a follow through on facts of which the attorney has inquiry notice. In both cases the lawyer's role is pivotal, he is in the best position to perform the function, and performance is not unduly burdensome. Furthermore, reasonable research of the law is clearly a duty owed the clients and recipients of opinions under state law. In addition, there is an increasingly large body of law to be consulted as judicial opin-

158 243 App. Div. at 142, 277 N.Y.S. at 175-76.

ions become more numerous, more detailed (and explicit) rules are promulgated, an increased number of SEC releases are issued, and no-action letters are published. Reasonable investigation will often yield no answer or conflicting answers, but since securities regulation is fast becoming like tax law in its use of explicit formulae and in the accumulation of judicial and administrative precedents, there are strong arguments that a lawyer's opinion implicitly represents reasonable research and consideration of relevant authority found. The time when the law of securities regulation primarily could involve only seat-of-the-pants judgments is gone. Different lawyers will handle the authorities, especially the published no-action letters, differently; for example, an unsupported SEC position in a published no-action letter certainly would not preclude a good faith judgment that the contrary position will ultimately prevail in court. Consultation of these authorities will, however, cause the lawyer to analyze the problem and the risks, which is in the best interests of clients, recipients of opinions, and the public.

4. Use of Paraprofessionals

Use by law firms of their paraprofessionals to work on disclosure documents becomes especially dangerous if courts impose demanding concepts of inquiry notice. The paraprofessional will usually have only a minor fraction of the lawyer's ability to spot and evaluate the potential significance of suspicious circumstances, especially when the circumstances concern mixed questions of law and fact. If lawyers wish to avoid burdens of factual investigation, a far safer alternative is greater lawyer programming of investigations by fairly senior company personnel familiar with the areas they investigate. The lawyer could establish a written program, insist upon memoranda, lists, and documentation, and could follow through himself only on the apparent trouble spots. In general, I believe *BarChris* should demonstrate that securities work is about the last place in a law firm where paraprofessionals can be utilized.

5. The Antifraud Rules and Suspension or Disbarment of Attorneys by the SEC

SEC Rules of Practice, Rule 2(e)[159] authorizes temporary or permanent denial by the SEC of the right to appear or practice before the agency. The Rule applies to any person found, *inter alia*,

> to have engaged in unethical or improper professional conduct or to have willfully violated, . . . [or] willfully aided and abetted the violation of any provision of the Federal Securities laws . . . or the rules . . . thereunder.[160]

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159 17 C.F.R. § 201.2(e) (1972).
160 *Id.*

Despite the obvious importance of rule 2(e) to lawyers doing securities work, I will not discuss the rule, which is covered in an excellent, recent Comment in the *Duke Law Journal.*[161]

F. *Uncertainties Concerning Lawyers' Responses to Auditors' Requests for Information*

Accountants preceded lawyers, by about a decade, as major targets of antifraud actions under the securities statutes. At present we are witnessing hard maneuvering by accountants vis-à-vis underwriters on comfort letters.[162] Fencing between lawyers and accountants will likely proceed on several fronts. One of the more active areas concerns broad requests by auditors about the attorney's knowledge concerning matters such as the client's liabilities in matters being litigated, contingent liabilities not presently involving claims or lawsuits, transactions not in the normal course of business, conditions concerning capital stock which would prevent it from being fully paid and nonassessable, and any other matters which may affect the assets, liabilities, or capital of the company. These requests are usually forwarded by the company to the attorney for his reply.

The proper form of reply raises most of the questions discussed in this article. The requests cannot be brushed aside or left unanswered, for the auditor might refuse to certify. On the other hand, the lawyer's response will obviously affect the certified financials ultimately used in securities transactions and disclosure documents, and the attorney must be careful not to misstate or mislead. Yet broad inquiries about possible contingent liabilities, transactions not in the ordinary course of business, and defects in capital stock will touch every raw nerve and possible disclosure skeleton in the corporation's past. I will not pursue the considerations in framing the reply, for they are discussed in an excellent recent article by Mr. Richard E. Deer, an Indianapolis attorney.[163]

III. THE LAWYER'S DUTY TO REPORT PROSPECTIVE VIOLATIONS AND TO WITHDRAW FROM REPRESENTATION

The suggestion that a lawyer representing a client which plans to disregard the lawyer's advice that a course of action is illegal must withdraw from representation and report the client's plan to the proper authorities is simultaneously the most controversial and the most unimportant of the developments concerning lawyers' duties under the securities acts. The ques-

[161] Comment, *SEC Disciplinary Rules and the Federal Securities Laws: The Regulation, Role and Responsibilities of the Attorney*, 1972 DUKE L. J. 968.

[162] *See* AICPA, STATEMENT ON AUDITING PROCEDURE NO. 48, LETTERS FOR UNDERWRITERS (1971).

[163] Deer, *Lawyers' Responses to Auditors' Requests for Information*, 28 BUS. LAW. 947 (1973). This article, which appears in the April 1973 issue of BUSINESS LAWYER, was circulated in reprint form early in 1973 to BUSINESS LAWYER subscribers.

tion is relatively unimportant because clients have seldom proceeded in the face of an attorney's advice that to do so is illegal and because in the future the situation will arise even less often.[163] One clear impact of *Garner v. Wolfinbarger*[164] will be almost total compliance with counsel's injunctions that a planned course of action is illegal or will create liability, for that advice is now subject to discovery by shareholders, and a management proceeding against counsel's advice surely builds a strong case against itself.

The ABA was correct when it argued in *Garner v. Wolfinbarger* that a failure to honor the attorney-client privilege in litigation between the corporation and shareholders will diminish candor by counsel in advising the corporation that certain action will be illegal. When presented with schemes that he believes are illegal, however, counsel will still be under strong pressure to be candid, for a hedged opinion allowing management to proceed can be costly to the corporate entity and a new management or a trustee in bankruptcy may be quite willing to ask counsel to defray the entity's losses from the lack of forthrightness. And as we have seen, corporate counsel's duties may now run both to the entity and to shareholders and prospective shareholders harmed by the lack of candor. Moreover, lack of a good faith belief in the opinion would place counsel afoul of the antifraud rules. In short, the pressures for candor are quite as strong as the counterpressure.

In any event, Opinion 314 of the ABA's Committee on Professional Ethics, the opinion concerning the ethical duties of tax lawyers to the Internal Revenue Service, dealt with a directly analogous question when it indicated that disclosure of even the client's confidences would be required "if facts in the attorney's possession indicate beyond reasonable doubt that a crime will be committed."[165] Disciplinary Rule 7-102(B)(1) of the new Code seems equally strong in stating that

> [a] lawyer who receives information clearly establishing that his client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal.[166]

In the securities area, a client proceeding in the face of counsel's advice that his conduct is illegal is "clearly establishing" in the attorney's view a criminal and fraudulent act. If the attorney is bound to blow the whistle when he discovers a fraud after the fact, he would seemingly be required to take reasonable steps to prevent its occurrence, notwithstanding the injunction to preserve client confidences. Disciplinary Rule 4-101(C)

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[164] Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971).

[165] AMER. BAR ASSOC., OPINIONS ON PROFESSIONAL ETHICS, 688, 691 (1967).

[166] ABA CODE OF PROFESSIONAL RESPONSIBILITY, DISCIPLINARY RULE 7-102(B)(1).

states that "a lawyer *may* reveal the intention of this client to commit a crime and the information necessary to prevent the crime."[167] Since prevention of the crime is the paramount aim, Disciplinary Rule 4-101(C) should be interpreted, in line with Disciplinary Rule 7-102(B)(1), to require the lawyer first to notify the client of the lawyer's proposed course of action if he does not abandon the plan. After this step is taken, few clients would proceed. If the logic of *Garner v. Wolfinbarger* is followed, corporate counsel will have a positive duty to their other clients, shareholders and prospective shareholders, that is at least as demanding as the duties under the Code of Professional Responsibility.

The attorney's obligations to the corporate entity itself may compel him to report serious violations or planned violations of the securities laws by the operating management to the entire board of directors, including particularly the outside directors. We have earlier discussed A.B.A. Opinion 202,[168] issued in 1940, in which an attorney retained by a corporation learned of questionable activities by its officers and was convinced that the officers would not make a full report to the board of directors. The Committee said the attorney "may and should" inform the board of directors. *Moses v. Burgin*[169] reinforces this concept, for the court deemed crucial management's failure to keep outside directors informed.

The subject of the duty to withdraw from representation after the attorney has publicly blown the whistle seems doubly academic to me. As indicated, there will rarely be need publicly to blow the whistle. And once it is done, I see no legal or ethical reason why counsel could not continue to represent the corporation if there is a change in management, and I would assume that if counsel is forced publicly to blow the whistle, the resulting trauma will force a change in management. If there is no change in management, I see every practical reason for counsel's orderly withdrawal from the client's affairs.

In one situation, the Code of Professional Responsibility arguably produces unappealing results in the securities context. Suppose a corporation is concerned about a disclosure document used in the past. It consults counsel, who analyzes it and finds it materially defective. The thrust of the Code is toward rectifying frauds committed by the client while the attorney represents it and toward preventing future crimes (not toward turning the lawyer into an informer concerning past crimes revealed to him in confidence). Yet, in our hypothetical case, if there is a trading market which is still being affected by the defective disclosure document, the attorney

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167 *Id.*, DISCIPLINARY RULE 4-101(C) (emphasis supplied). The notes to Rule 4-101(C) here cite to AMER. BAR ASSOC., OPINIONS ON PROFESSIONAL ETHICS, No. 314 (1965), which states that an attorney *must* disclose such confidences.

168 AMER. BAR ASSOC., OPINIONS ON PROFESSIONAL ETHICS 486 (1967), discussed in text accompanying notes 83-84 *supra*.

169 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971).

must advise the corporation that failure to correct the document is a crime and a fraud—there is a continuing wrong. If the corporation does not issue a public correction, the Code of Professional Responsibility requires the attorney to request correction, and failing that, to notify the trading markets (probably through the SEC).

Again, the logic of *Garner v. Wolfinbarger* might require the same result, since there is a continuing series of injuries to trading market purchasers in addition to a consultation about the completed transaction. It is not wholly satisfying to see our corporate management be placed under the gun because of their consultation with counsel about a past transaction, and the seeming result under the Code will not encourage consultation and openness in communications with lawyers.[170] On the other hand, the past act is projecting into the future and continues currently to injure investors. There are strong arguments for treating the continuing fraud or crime the same as a wholly prospective one.

IV. Scope of the SEC's Rulemaking Powers to Specify Attorneys' Duties

The antifraud proscriptions of Securities Act § 17(a) and Exchange Act rules 10b-5 and 14a-9 create most of the uncertainties concerning attorneys' duties, and hence their civil liabilities, under the federal securities statutes. We have seen that the express liabilities prescribed in §§ 11 and 12(2) will seldom apply to attorneys, who are seldom "experts," "issuers," or "underwriters" under the former section or "sellers" under the latter section; and once attorneys come within the scope of these sections, the fault standard, knowledge or failure reasonably to investigate facts and the law, is quite clear. There is an interesting uncertainty concerning SEC powers to require additional legal opinions in registration statements and hence to bring attorneys into greater contact with § 11. Attorneys resist efforts of securities administrators to require them to supply legal opinions forming a part of registration statements and prospectuses, but my impression is that through informal negotiation securities administrators are requiring such opinions on a broader number of issues and that with strong client and underwriter pressures for effectiveness the efforts are becoming harder to fend off.

But the antifraud provisions are of central importance to attorneys. Section 11 does not contemplate attorneys' "expertising" of large portions of the registration statement.[171] The antifraud provisions, being applicable to all persons, whether or not in privity with purchasers and sellers, are the primary governors of attorneys under the federal securities statutes.

[170] Mr. Monroe H. Freedman has noted that Code of Professional Responsibility, Disciplinary Rule 7-102(B)(1) abridges the confidentiality of the lawyer-client relationship. Letter to Editor, 59 A.B.A.J. 114 (1973).

[171] *See* Escott v. BarChris Construction Co., 283 F. Supp. 643, 683 (S.D.N.Y. 1968).

We shall also put rule 14a-9 to one side and concentrate upon rule 10b-5 and § 17(a). Whenever a proxy solicitation is made in connection with an offer or purchase or sale of a security, both rules 10b-5 and 14a-9 apply, although the former seems to encompass everything reached by the latter. There are proxy solicitations which involve no securities transactions but which might create major questions about the duty of the attorney under rule 14a-9. But these instances are much less important than the variety of transactions covered by rule 10b-5, and rule 10b-5 is broader in the principals ("any person") covered by its injunctions than is rule 14a-9 (persons making solicitations).[172] Moreover, rules under § 10(b) stating when attorneys will and will not run afoul of rule 10b-5 can extend to rule 14a-9 the safe harbors and defenses provided for rule 10b-5.

What then is the extent of the SEC's power concerning rule 10b-5 and § 17(a)? Both the Securities Act and the Exchange Act delegate far-reaching rulemaking authority to the SEC. Aside from the customary authority to issue rules necessary in the administration of the statutes—a grant probably carrying with it only the authority to issue what Professor Davis labels "interpretative" rules[173]—both statutes authorize the SEC (1) to define "technical, trade, and accounting terms"[174]; and (2) to classify persons subject to their jurisdiction and prescribe varying requirements, though in the Securities Act this authority seems to apply only to the required contents of registration statements and prospectuses.[175] These delegations authorize what Professor Davis calls "legislative" rules.[176] Rule 10b-5, furthermore, implements Section 10(b), which has force only to the extent SEC rules actually implement it. The Securities Act and the Exchange Act also provide an immunity for acts done or omitted in good faith in conformity with an SEC rule even when the rule is later amended, rescinded, or declared invalid by a court.[177]

The courts have almost invariably upheld SEC rules. Exemptions from § 16(b) of the Exchange Act pursuant to an authority to exempt consistent with the "purposes" of the section have sometimes been invalidiated or questioned, but most of the defendants in the actions in which invalida-

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[172] This means that in order for Rule 14a-9 to reach attorneys, concepts of aiding and abetting and conspiracy would usually be required. On aiding and abetting and conspiracy, *see* Ruder, *supra* note 101.

[173] The grants of authority to issue rules necessary in the administration of the statutes are found in Securities Act § 19(a), Exchange Act § 23(a). On interpretative rules, see 1 K. DAVIS, ADMINISTRATIVE LAW §§ 5.03-.05 (1958, Supp. 1965).

[174] Securities Act § 19(a), 15 U.S.C. § 77s (1970); Exchange Act § 3(b), 15 U.S.C. § 78c(b) (1970).

[175] Securities Act §§ 7, 10(a)(4), 10(c), 10(d), 15 U.S.C. §§ 77g, 77j(a)4, 77j(c), 77j(d) (1970); Exchange Act § 23(a), 15 U.S.C. § 78w(a) (1970).

[176] *See* 1 K. DAVIS, ADMINISTRATIVE LAW §§ 5.03-.04 (1958, Supp. 1965).

[177] Securities Act § 19(a), 15 U.S.C. § 77s(a) (1970); Exchange Act § 23(a), 15 U.S.C. § 78w(a) (1970).

tion occurred qualified for the good faith immunity.[178] Testing of any rule for lack of overall consistency with the judicially perceived purpose of the statute is an ever present outer limit of the SEC's rulemaking authority, even when the most explicit broadly phrased legislative rulemaking power is exercised.[179] In the scheme of the relationship between the SEC and the judiciary, the judiciary has at least that ultimate role in reviewing the SEC's rules.

On similar grounds, I argued elsewhere[180] for the invalidity of rules of the Comptroller of the Currency, issued in 1963 and rescinded in 1971, that a violation of his regulations under the Exchange Act (which are applicable to national banks required to register under § 12 of that Act) would not create an implied private right of action.[181] A rule, whose sole purpose is to negate implied private rights otherwise flowing from violations of the statute and the agency's regulations, attempts to displace a long-standing function of the judiciary (which historically has created or refused to create implied private rights of action for violations of the statutes and agency regulations) and should be considered ultra vires, though perhaps of the same advisory persuasiveness as an amicus curiae brief.[182]

Absent an express delegation of a power to determine which violations of statutes and rules will create private rights of action, the agency should be without jurisdiction to reverse the historical practices and order the courts to imply, or not to imply, a private right of action for violations of the statute or a rule. The statutes give no hint of an express delegation. For example, the contract-voiding provisions of the statutes, which are one of the bases of implied private rights, contain no "technical, trade or accounting terms" to be defined. Furthermore, the immunity, found in both statutes, for acts done in good faith reliance would not shield a violator unsuccessfully invoking a negation rule in implied private rights litigation. If the negation rule were found invalid, good faith reliance upon it could not be shown. The negation rule would not have assured the defendant it was lawful to commit the act, but rather would have told him that, although he will be liable for administrative, injunctive and criminal

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178 *See* II L. LOSS, SECURITIES REGULATION 1114-17 (1961, Supp. 1969). In Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970), the court made it plain that exemptions from Exchange Act § 16(b) would continue to receive close scrutiny in the Second Circuit.

179 *Cf.*, e.g., United States v. Cartwright, 41 U.S.L.W. 4593 (U.S., May 7, 1973); Estate of Willett v. Commissioner, 365 F.2d 760 (5th Cir. 1966).

180 Shipman, *Two Current Questions Concerning Implied Private Rights of Action Under the Exchange Act: Authority of the Administrative Agency to Negate; Existence for Violation of Self-Regulatory Requirements*, 17 CASE W. RES. L. REV. 925 (1966) [hereinafter referred to as Shipman].

181 The rules are found in 12 C.F.R. §§ 10.2, 16.11 (Supp. 1965), *as amended*, 31 Fed. Reg. 6949-57 (May 12, 1966). Rescission of the negation rules came in the 1971 revision. *See* 36 Fed. Reg. 14997-15035 (Aug. 12, 1971).

182 *See* Shipman, *supra* note 180, at 925-63.

penalties if there is a violation of the statute, he will not be liable to private persons injured by his violation.[183]

It is quite different when the SEC tailors its rules to determine the reach of the statute for all purposes. The SEC is not attempting to specify the remedies for violations. It is stating that there will or will not be a violation, a judgment that the purposes of the statute are best served if the act is proscribed or put beyond the reach of the statute for all purposes. This type of rulemaking jurisdiction is one clearly committed to the SEC.[184]

Outer limits on the stringency of rules applicable to attorneys flow from the limitation in § 10(b) of rulemaking authority to proscription of "deceptive or manipulative" devices or contrivances. The on-going debate concerning the degree of fault or scienter required before rule 10b-5 is violated relates, in part, to doubts about the outer limits of § 10(b).[185] It would, for example, be highly doubtful that the SEC could by rule make unlawful an attorney's erroneous opinion if good faith and reasonable care accompany preparation of the opinion. It is also highly academic to consider whether such a rule would be valid, for rule 10b-5(2), which literally seems to proscribe material misstatements and half-truths without regard to scienter or fault, was held in *Texas Gulf Sulphur* not to reach material misstatements made in good faith and after reasonable care had been exercised.[186] The SEC has not indicated any quarrel with that holding, and indeed everyone seems to assume that a combination of good faith and reasonable care is certainly a valid defense to actions under the antifraud rules.[187] Rules governing attorneys' duties would revolve around the question whether lack of either good faith or reasonable care should constitute sufficient fault to bring the attorney within the ambit of rule 10b-5. This seems well within the scope of § 10(b).[188]

Section 17(a) of the Securities Act poses no special problem to the extent that it does not reach many transactions regulated by rule 10b-5—for example, misstatements or fraudulent acts by a purchaser, which are outside the scope of § 17(a). Section 17(a) may also be more limited in its application to persons not in privity with a purchaser affected by a misstatement or a fraud. In any event, when § 17(a) and rule 10b-5 both apply to attorneys, parallel rules under § 17(a) and § 10(b) of the Exchange Act

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183 *See* Shipman, *supra* note 180, at 961-63.

184 *See, e.g.*, text accompanying notes 173-78 *supra*.

185 *See, e.g.*, Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., CCH FED. SEC. L. REP. ¶ 93,773 (10th Cir. 1973). For a comprehensive discussion of scienter and fault standards, see Chris-Craft Industries, Inc. v. Bangor Punta Corp., CCH FED. SEC. L. REP. ¶ 93,816 (2d Cir. 1973).

186 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 861-63 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

187 *See* Gould v. American Hawaiian Steamship Co., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,682 (D. Del. 1972).

188 *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971): "Section 10(b) must be read flexibly, not technically and restrictively."

could be adopted. The rules under § 17(a) would seem to be interpretative, as opposed to the legislative nature of rules under § 10(b). Because of the recent tendency to equate rule 10b-5 and § 17(a) where they overlap[189]—a most natural action since rule 10b-5 was modeled upon § 17(a) —rules interpreting § 17(a) on questions such as fault and scienter would surely be accepted if parallel rules under § 10(b) of the Exchange Act governing the application of rule 10b-5 were upheld.

Another source of SEC authority concerning the duties of attorneys arises from the SEC's power to condition exemptions upon an attorney's undertaking certain responsibilities. So far this has been a little-used power. The major exemptive rules—Rule 144, Regulation A, and proposed Rule 146—say nothing about the participation of an attorney. It would, however, be logical to condition some exemptions provided by rule upon the prior obtaining of an appropriate written opinion of counsel addressed to affected parties and meeting requirements laid down by the SEC. This concept has been employed by the California Securities Act, which requires counsel's opinion that the organizational offering exemption is applicable as a condition to its availability.[190] The SEC has seldom employed this technique, although the new rule concerning self-underwritten offerings by SECO broker-dealers is an extreme application: one of the conditions to be met before an SECO broker-dealer can act as a direct distributor of its securities to the public is that an independent counsel opine that there is no violation of the federal securities statutes, an opinion which seemingly would require counsel to verify all facts in the prospectus.[191]

A variant of this general concept of conditioning favorable treatment upon the prior obtaining of counsel's written opinion is now employed in the SEC's no-action letter process, where such an opinion (expressed to the SEC) is a necessary, though obviously not necessarily sufficient, condition to issuance of a no-action letter.[192] The concept could be expanded. As counsel undertakes greater responsibility to his client and investors, faster processing and less pre-transaction governmental scrutiny are in order.

Attorneys' duties are subject to SEC rulemaking power in another, closely related way. If the SEC were to establish, by rule, express partial defenses for acts done or omitted in reasonable reliance upon counsel's opinion, a part of the equation would involve a specification of the types of opinions supplying the defense and of attorneys' duties under the securities statutes in giving such opinions.[193] This type of framework prevails

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[189] *See* Globus v. Law Research Service, Inc., 418 F.2d 1276, 1283-87 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

[190] CAL. CORP. CODE § 25102(h)(5) (West Supp. 1972).

[191] 17 C.F.R. § 240. 15b10-9, *adopted in* SEC Exchange Act Release No. 9883 (Dec. 4, 1972).

[192] *See* 4 CCH FED. SEC. L. REP. ¶ 66,481.10.

under § 11 on those relatively few items of information with respect to which counsel is an expert within the meaning of that section, and the defense to which one relying upon counsel's opinion is entitled is always intertwined with the attorney's duties. As the responsibility undertaken by the attorney increases, the defenses provided by reliance upon his opinions should expand.

V. DESIRABILITY OF SEC RULEMAKING AND THE INDICATED DIRECTIONS

There are substantial arguments that the SEC should do nothing concerning the developing uncertainties about attorneys' duties. After all, the courts have generations of experience in dealing with fraud, negligence and recklessness in privity and non-privity situations. Courts are sophisticated about the ultimate, often conflicting considerations—who are the best cost avoiders, who are the best loss bearers, fairness, and how thoroughgoing a quest for fairness and full and accurate information should the system undertake in order to thrive and expand.[194] Moreover, the securities statutes leave available to underwriters and other purchasers from the issuer the possibility of negotiating for more comprehensive opinions than counsel now give. Indeed, to the extent the underwriter requires tax, patent, title or similar opinions to be described in the prospectus pursuant to a consent filed by counsel, the underwriter is obtaining some protection for itself under § 11 and at the same time obtaining direct protection under the same section for the public. For sufficient consideration—which would be borne by the issuing company, the promoters, the selling shareholders, the underwriters, and the ultimate purchasers in some undetermined proportions—counsel can be induced to expand their opinions. For example, if legal opinions in underwritings are skeletal on key points, it is because sophisticated intermediaries to whom the opinions are addressed—the underwriters—have accepted them, evidencing a belief that more is not desirable.

This latter argument—leave it to the market—was of course rejected

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193 *Cf.* Treas. Reg. § 53.4945-1(a)(2)(vi):

> If a foundation manager, after full disclosure of the factual situation to legal counsel . . . relies on the advice of such counsel expressed in a written opinion that an expenditure is not taxable expenditure . . . [then, even if counsel is wrong] the foundation manager's agreement to such expenditure . . . will ordinarily not be considered "knowing," or willful" and will ordinarily be considered due to reasonable cause . . . . A written legal opinion will be considered "reasoned" even if it reaches a conclusion which is subsequently determined to be incorrect so long as such opinion addresses itself to the facts and applicable law. However, a written legal opinion will not be considered "reasoned" if it does nothing more than recite the facts and express a conclusion.

194 For provocative theoretical analyses of the ultimate purposes of torts law, see Conard, *A Behavioral Analysis of Directors' Liability For Negligence*, 1972 DUKE L.J. 895; G. CALABRESI, THE COST OF ACCIDENTS — A LEGAL AND ECONOMIC ANALYSIS (1970); Posner, Book Review, 37 U. CHI. L. REV. 636 (1970); Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29 (1972); Calabresi & Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L. J. 1055 (1972).

when Congress enacted the securities statutes. Contract provisions could theoretically approximate § 11 allocations of the risks of inaccurate information, and in any privity situation, the purchaser can always, at least theoretically, attempt to exact warranties going at least as far as the antifraud rules. What Congress perceived, however, in the 30's was that the direct and indirect bargaining power of the public to obtain adequate information had been insufficient, severely aggravating an all-important public distrust of corporate securities.[195] Nonwaivable norms of disclosure were deemed a necessary foundation for public confidence (and hence a lower cost of capital).[196]

Congress also shrewdly perceived in § 11 that persons other than the issuer might be the best preventers of defective disclosure. For this reason, underwriters, "experts," directors, the top operating and financial officers, and the certifying accountants were held to duties of reasonable investigation. The antifraud sections, by eschewing a limitation to the persons actually buying or selling securities, demonstrate the same general thrust. It is this statutory structure of nonwaivable norms of disclosure and of coverage of everyone having significant contracts with the marketing of securities which the SEC must cause to work. The SEC is, moreover, subject to a practical charge, perhaps to an unrealistically large degree, to maintain public confidence in the markets.[197] The SEC's discretion to move toward a model leaving information production and verification primarily to market forces is thus limited by law and political forces. This is especially so when one considers that the free alienability of most corporate securities causes information deficiencies that at first concern the issuer and the purchaser ultimately to come to rest upon and play havoc with the trading markets, where contractual negotiation with the issuer for information is next to impossible.

The choice on rulemaking versus reliance upon judicial development is not dependent upon whether rulemaking might be so extensive as to leave little role for the courts in the development of the law. Since the focus upon the uncertainties facing attorneys is so recent, I cannot imagine anyone so bold or foolhardy as to suggest that rulemaking can answer all questions. Furthermore, thirty years experience with lengthy, prolix internal revenue acts and regulations interpreting them suggest that the judiciary is in no danger of being reduced to a mere fact-finder even under the most

[195] *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 847-48, 851-52, 858-62 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[196] Both the Securities Act and the Exchange Act void waivers of compliance. Securities Act § 14, 15 U.S.C. § 77n (1970); Exchange Act § 29(a), 15 U.S.C. § 78cc(a) (1970).

[197] In SEC Exchange Act Release No. 9950 (Jan. 16, 1973) (adoption of exchange insti-tuitional membership rule), the SEC boldly asserted authority and responsibility concerning the securities markets and the securities traded there. For reservations about the SEC's proper role in promoting positive attitudes, see Cary, *Foreword* to S. ROBBINS, THE SECURITIES MARKETS vii-ix (1966).

heroic attempts at comprehensiveness in statutes and regulations. We have had sufficient experience with rulemaking to indicate, however, that rulemaking can be helpful when there is agreement only on maxima and minima and the desired results in frequently recurring situations, although the agency may be unwilling or unable to attempt to formulate the principles in fully developed form.[198]

In this article, I have attempted to describe perhaps half a dozen frequently recurring situations to which there should be fairly definite answers and to which such answers can be supplied by regulations with numerous examples.[199] Any such rulemaking effort would necessarily be incomplete and would require supplementation by judicial and SEC decisions applying the general antifraud rules. The regulations themselves would, however, be proper precedent for analogical reasoning in much the same manner that statutory resolutions in other jurisdictions can be proper precedent for a court making a common law determination.[200]

A. *Advantages*

Rulemaking has two central advantages. One is that the clearest possible standards are needed concerning the duties imposed upon attorneys by the antifraud rules to notify investors or the SEC of disclosure deficiencies of the corporate client. American lawyers properly take quite seriously the duties of loyalty to the client and preservation of its confidences, and attorneys will need the most explicit possible legal standards to guide them as we enter what appears to be an era of expanding notions of shareholders and potential shareholders as common clients with the corporation. In general these notions are logical and beneficial in the context of compliance with the securities statutes, but they run counter to corporate counsel's intuition and training. Corporate counsel, moreover, owes his position to management, and in a society as aggressive and success-oriented as ours, only the most unambiguous legal standards will cause corporate counsel to fully recognize the emerging legally required increase in the division of loyalties of corporate counsel between the corporate entity and investors in it. Most importantly, management itself is entitled to know the extent of the attorney's division of loyalties.

Another reason for rules governing the duties of attorneys flows out of the fact that compliance with the securities statutes is a team effort by company personnel, accountants, underwriters and lawyers. In the absence of rules concerning the role of lawyers, the current scare about the attorney's possible liabilities may lead him either to attempt to avoid responsi-

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198 *See* K. DAVIS, DISCRETIONARY JUSTICE 59-64 (1969).

199 Treasury Regulations under the Internal Revenue Code effectively employ numerous examples. The SEC's rules usually shun examples.

200 *See* Moragne v. States Marine Lines, Inc., 398 U.S. 375 (1970).

bilities for which he is best fitted or to perform needless duplication of investigation performed by others. In securities work, there has been little systematic analysis attempting to determine the optimal use of the attorney in producing compliance. A rulemaking proceeding that would as a first order of business gather information and give hard study to the costs of lawyer involvement and to the areas in which his involvement is crucial would seem a prerequisite to a system making the best use of the lawyer's time and talents.

A proceeding looking toward prospective rules would not limit the SEC if it found cases which should be tried in injunctive or similar actions under the present form of rule 10b-5. When the SEC considers an application of rule 10b-5 in a disputed area outside the results in prior litigated cases, there is some propensity to treat litigation and rulemaking as mutually exclusive—which ignores the prospective nature of rulemaking. Since the SEC's rules have invariably been prospective, a rulemaking proceeding and new rules would not interfere with the proper trial of pending cases. At the same time, the adoption of prospective rules defining what rule 10b-5 requires of attorneys need not undermine the SEC's position on the reach of rule 10b-5 at present. The new rules could be accompanied by a declaration that no inference is to be drawn from the action concerning the reach of present law, which would govern alleged violations occurring before the new rules.

Interpretation of statutes and rules has progressed to the point that prospective modification of a standard is no longer taken as an indication by the legislature of the reach of standard before its modification, especially when the legislature disclaims any such implied interpretation.[201] When the SEC spots an emerging problem, litigation may be the appropriate first response. A dramatic case captures attention and focuses it upon the problem, often the necessary initial step. The litigation should not, however, obscure the facts that rulemaking may be the long-range solution and that the prospective rulemaking proceeding need not interfere with the litigation or assertion of the SEC's position under prior law.

B. *Alternatives*

If there is to be a code governing attorneys' duties in securities work, why shouldn't the code be a part of the ABA's Code of Professional Responsibility? The AICPA has, for example, taken quite seriously the view in *BarChris* that the standards of the profession set accountants' duties of reasonable investigation under § 11 and has issued a number of statements, including one on comfort letters, designed to set standards for accountants in securities work.[202] The SEC has commissioned the NASD to

201 On the administrative front, see SEC Exchange Act Release No. 8712 (Oct. 8, 1969).

202 *See* text accompanying notes 100-104, 162 *supra*. In Escott v. BarChris Constr. Co., 283

set standards of reasonable investigation by underwriters in public offerings.[203] A prominent securities lawyer who was formerly Associate General Counsel of the SEC and a member of that body has asked the President of the ABA to appoint a special committee to work with the SEC to set guidelines protecting lawyers.[204]

I prefer SEC rules governing attorneys' duties in securities work for two closely related reasons. First, only SEC rules can provide needed protections for lawyers when those protections are needed. *Garner v. Wolfinbarger* demonstrated that ABA pronouncements, even one so formal and carefully considered as the Code of Professional Responsibility, are properly to be considered advisory when, as is often true, the litigation before the court presents major issues affecting the public.[205] Secondly, the SEC is, of course, far better structured to be forced to consider the interests of investors—and indeed of issuers, company personnel, underwriters, and accountants—as they are affected by a code of conduct for lawyers in securities transactions.

Congress also seems a less appropriate forum than the SEC for resolution of these issues, at least initially. The best answers are likely to emerge only after immersion into the nitty-gritty of securities transactions. And an ability rather quickly to change standards that prove unduly burdensome or ineffective seems essential. After all, thought has been devoted to these questions only since the *BarChris* decision in 1968 stirred the interest of the bar in attorneys' duties and vulnerability. Moreover, the SEC in the past two years has shown an increased zest for tackling the toughest problems by rules.[206] Lastly, the SEC is close enough to the bar to understand attorneys' strengths and yet sufficiently underwhelmed to evaluate and correct the weaknesses of current practices.

C. *Indicated Directions for Rulemaking*

As I indicated at the beginning of this article, I have not attempted to formulate an outline or a draft of the ultimate rules that might be adopted. It would be presumptuous for me to do so, because a hard, detailed, pragmatic examination of the attorney's interaction with other participants in a variety of securities transactions is a precondition to optimal rules govern-

F. Supp. 643, 703 (S.D.N.Y. 1968), Judge McLean stated that "[a]ccountants should not be held to a standard higher than that recognized in their profession."

203 SEC Exchange Act Release Nos. 9670-71 (July 26, 1972).

204 BNA SEC. REG. & L. REP. No 182, A-2 (Dec. 20, 1972).

205 The preliminary statement in the American Bar Association's Code of Professional Responsibility declares that the Code does not "undertake to define standards for civil liability of lawyers for professional conduct."

206 *See, e.g.*, 17 C.F.R. § 230.144, adopted in SEC Securities Act Release No. 5223 (Jan. 11, 1972); 17 C.F.R. § 230.145, adopted in SEC Securities Act Release No. 5316 (Oct. 6, 1972); Proposed Securities Act Rule 146, SEC Securities Act Release No. 5336 (Nov. 28, 1972); Proposed Securities Act Rule 147, SEC Securities Act Release No. 5349 (Jan. 8, 1973).

ing attorneys' duties. It is appropriate, however, for me to indicate some considerations that might be kept in mind as such rules are drafted.

The SEC should specify when counsel is expected to notify affected investors or the SEC of a client's disclosure deficiencies. Though largely academic, of all the questions discussed in this article, this question most excites the bar. A focus upon specifics can convert the heat into light, and well-defined rules will in a sense moot the question, as counsel will not need to take the ultimate step if everyone is aware when counsel must request the client to disclose an error or to abandon a planned violation and must notify investors or the SEC if the client does not comply.

A major consideration in fashioning rules is that direct purchasers may contract for greater counsel responsibilities. This should carry considerable weight in defining the nonwaivable duties which the antifraud rules place upon attorneys. Underwriters, broker-dealers, and institutional investors have the savvy and the financial self-interest to appreciate the increased protections that stronger legal opinions provide. They also have considerable ability to shift the costs back to the issuer or selling shareholder or forward to purchasers. The best practices of these securities sophisticates are thus highly relevant.

Many current uncertainties concern the allocation of functions among company personnel, counsel, accountants, and underwriters, and I don't see a consensus emerging among those groups, each running scared of liabilities. The sparring between accountants and underwriters over comfort letters appears not to have ended with the issuance in 1971 of the AICPA's cautious Statement on Auditing Procedure No. 48, *Letters for Underwriters*.[207] Counsel and accountants cannot each be expected to grab the responsibility for the no-man's land of material figures that seem not to fit in the certified financials because they are not based upon historical costs.[208] In *Gould v. American-Hawaiian Steamship Co.*,[209] the directors held negligent in reviewing the defective proxy statement unsuccessfully argued reasonable reliance upon counsel, and in general, we can anticipate more than a few post hoc jurisdictional disclaimer disputes between company personnel and counsel.

The SEC's foremost responsibility is to ensure that gaps do not develop because of a failure expressly to allocate responsibility in advance and that fear of liability does not create unnecessary duplication. Disclosure documents should be required to specify who has checked what and the responsibility undertaken by each participant, thus encouraging a definite allocation of responsibilities before work on the disclosure document begins. Investors should know how the information was put together and the ex-

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[207] *See* text accompanying note 162 *supra.*

[208] *See* text accompanying notes 57-60 *supra.*

[209] CCH FED. SEC. L. REP. ¶ 93,682 (D. Del. 1972).

tent to which counsel stands behind it. Disclosure of agreed-upon allocations of effort should be supplemented by specified minimum standards for each participant. This involves an analysis of comparative advantages. For example, issuer's counsel should not be required to conduct a "reasonable investigation" of all facts in a registration statement even if the SEC had the authority to require this (which it does not), for much factual investigation is performed as well or better with less expense by others. On the other hand, counsel is best equipped to devise a plan detailing efforts by him and by others that should, if properly executed, add up to a reasonable investigation; and disclosure of existence and compliance with such a plan would seem appropriate.

A concept of attorneys' work papers and work programs should be instituted by SEC rules. This may not be received well by the bar, but it is a necessity. Attorneys already resent the extent to which their duties and work procedures are coming to resemble those of accountants, but specified systematic procedures as a starting point (always to be supplemented when required or modified when the procedures make no sense) are useful in a complicated transaction, especially one demanding high disclosure standards concerning all material facts.

SEC rules requiring counsel to follow through, in any disclosure matter, if he has inquiry notice would use well the considerable knowledge of counsel and would clearly be authorized by § 10(b). Likewise, requiring that counsel's favorable opinion on an exemption issue only if he has proceeded in good faith and with reasonable care to research the law and the factual base would use to good advantage the attorney's superior ability to locate and evaluate the law and facts central to the exemption issue and would be within § 10(b). Terms such as "reasonable investigation" can and should be defined to exclude efforts with a small probable informational return and to allow considerable reliance upon clients. In general, the most meaningful SEC rules will be those specifying what constitutes a reasonable investigation for participants in securities transactions.

Perhaps the most difficult consideration for the SEC, and the courts, to deal with precisely is Judge Cardozo's concern in *Ultramares Corp. v. Touche*[210] echoed by Judge Friendly's concurring opinion in *Texas Gulf Sulphur*,[211] about indeterminate liabilities to indeterminate classes. Law firms themselves are less capable loss bearers than thousands of atomized investors. On the other hand, the purpose of civil liabilities under the federal securities statutes is more heavily weighted toward maintenance of high standards of disclosure rather than toward full compensation for losses.[212] Attorneys are as central to the disclosure process as accountants,

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[210] 225 N.Y. 170, 174 N.E. 441 (1931).

[211] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 864-69 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[212] *See* SEC Exchange Act Release No. 9671 at 6-7 (July 16, 1972).

underwriters and company personnel and they cannot hope to lag far behind them in duties to investors and liability exposure.

Attorneys are now much closer to those groups in liability exposure than the bar realizes. An issuer's counsel falsely opining to underwriters that he knows of no material misstatement or half-truth in a prospectus would surely be liable in damages to all public purchasers[213] from the underwriter (not to mention the underwriter)[214] and liability may flow if issuer's counsel had simply been on inquiry notice of the misstatement or half-truth. And in any event many serious disclosure deficiencies to which counsel is close will raise triable issues of lack of good faith belief which, if resolved adversely, will create liability. In a large offering or merger, liability in the millions is possible.

The SEC can profitably take a close look at liability policies available to law firms, and a major objective in fashioning rules should be to attempt to limit exposure so as to ensure that such coverage is generally available for securities lawyers. Such coverage is a necessity for those who desire intertemporal spreading of major risks as much as the next person and who are forbidden by the Code of Professional Responsibility and the federal securities statutes from shifting, by contract, liabilities to their clients and from exculpation. Moreover, liability coverage for conduct falling short of willful wrongs seems to be encouraged by our torts system,[215] has not been discouraged by the SEC in similar contexts,[216] and provides a potential source of recovery by investors. The SEC should keep this and other aspects of civil liabilities on the scales as it refines its antifraud rules to provide a code of conduct for securities lawyers. One of the advantages of a code provided by SEC rules is that those rules can provide appropriate truly safe harbors to keep liabilities in bounds.

Also desirable is a sharp consciousness of the effect of civil liabilities in general and of a code of conduct for securities lawyers in particular on the securities offerings of small issuers. Underwriters, lawyers and accountants appreciate the inverse, almost geometric relationship between the size of the issuer and exposure to some liability. The small issuer usually is issuing a security carrying greater risk; investors become interested in lawsuits when a security falls in value, not when it prospers, and a larger per-

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[213] *Cf.* United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970); Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

[214] *See* text accompanying notes 33-41 *supra.*

[215] Financial responsibility laws concerning motorists are a good example of encouragement of insurance. For conduct falling short of a willful wrong, there appears to be no general public policy against insurance coverage. *See* R. KEETON, BASIC INSURANCE LAW §§ 5.3(e)-(f) (1971).

For stimulating thoughts on directors' liability and insurance and indemnification arrangements covering them, see Conard, *A Behavioral Analysis of Directors' Liability for Negligence,* 1972 DUKE L.J. 895.

[216] *See* SEC, Guide to Preparation and Filing of Registration Statements, Item 46(c), 1 CCH FED. SEC. L. REP. ¶ 3806.

centage of small issuers' securities will decline in value. It is, moreover, much easier to make a material misstatement or omission in describing a small issuer; with a large enough company a slip concerning a $1,000,000 item will not be material. In addition, the small issuer will lack the internal controls of a larger company and often has no certified financials. Lastly, in a large offering, legal and accounting fees are a smaller percentage of the offering price and hence legal requirements of greater care will meet less resistance; for the small issuer, blue sky laws can provide a legal maximum.[217] While the large offering carries some exposure to large liability, a small issuer's offering is perhaps a higher risk operation. In devising rules governing attorneys' duties, it would be most unfortunate to set standards that will work well for the attorney advising the NYSE company but which are impractical for the counsel advising the local manufacturer making a Regulation A offering. The small company usually must have the best affordable counsel to have a fair chance of survival. SEC rules making it dangerous to represent the small issuer would be a regression. Investors must be told of the inherent high risk in small issuers' securities and suitability concepts can be employed, but the flow of responsible professional help for the small issuer must not be stifled.

An SEC codification of attorneys' duties might also provide express partial defenses for persons reasonably relying upon specified types of attorneys' written opinions. Suppose, for example, that an issuer asks a broker-dealer to privately place some of its debt securities. There are no violations of the antifraud rules, and the broker-dealer's securities counsel advises it, keeps on top of the facts, reasonably researches the law, and in good faith issues a written opinion that the private offering exemption is available. The broker-dealer reasonably relies upon the opinion. Later, a court, in a private action by one of the purchasers under § 12(1), disagrees on the law and holds the exemption unavailable. The broker-dealer was not negligent in its determination of the law: reasonable reliance on advice of counsel is one way of showing due care.[218]

The reliance is probably no defense in the § 12(1) action, for fault or scienter (other than a proof of no fault due to good faith reliance on SEC rule) plays no part in those actions; and indeed due care in predicting the reach of the federal securities statutes would seem no defense to a determination of whether any of the sections have been violated.[219] It would go well beyond stare decisis to allow due or good faith belief on the state of the law to be a complete defense, and the closest the securities statutes

217 For provocative thoughts and interesting data on blue sky laws, *see* J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS (1971).

218 *See* Comment, *Reliance on Advice of Counsel*, 70 YALE L. J. 978, 979 (1961).

219 A defendant presenting that defense may strengthen the possibility of a prospective overruling, if the precedent relied upon was settled. Concerning prospective overruling in tort cases, see R. KEETON, VENTURING TO DO JUSTICE (1969).

come to that is good faith action in reliance upon an SEC rule. In an interesting recent Truth-In-Lending case, a section of that statute which could have been literally interpreted to immunize acts pursuant to a good faith erroneous interpretation of the law was quickly construed by the court to protect only good faith clerical errors.[220]

In civil damage actions against police officers who have unlawfully arrested or searched, the officers do have a defense if they can show both good faith and reasonable belief in the legal validity of the arrest or search.[221] Arguably the broker-dealer is in much the same position as police officers and should be allowed to show its reasonable care in determining the law as a defense even to the private action under § 12(1). The answer, of course, is that such a delegation of power to lawyers is usually alien to our conception that the lawyer's interpretation, no matter how reasonable and well considered, cannot freeze the law and its growth and adaptive processes. The importance of encouraging law enforcement officials to act upon a reasonable belief is more manifest than encouraging a broker-dealer with a similar belief. Furthermore, at least in unlawful searches and seizures, the injured person can be only partially bound through the law enforcement officer's reasonable belief. The reasonable belief may relieve the officer from civil liability but the courts in the trial of the accused may expand what was previously thought to be the suspect's legal protections, hold the search to be illegal, and refuse to admit its fruits. Allowing the broker-dealer no defense to the § 12(1) action because of his reasonable reliance upon counsel thus appears proper.

Should the broker-dealer nevertheless have a complete defense against governmental actions brought after the fact? As a practical matter, such governmental actions would seldom be brought in the situation I have described. But suppose such an action were brought. A criminal conviction requires proof of a "willful" violation.[222] The law seems surprisingly unsettled concerning reliance upon counsel as a defense in a criminal ac-

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220 Ratner v. Chemical Bank New York Trust Co., 329 F. Supp. 270, 278-82 (S.D.N.Y. 1971); *but cf.* United States v. Von de Carr, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,481 (C.D. Cal. 1972).

221 On remand, the Second Circut held in Bivens v. Six Unknown Named Agents of Federal Bureau of Narcotics, 456 F.2d 1339 (2d Cir. 1972), that this standard was applicable to a claim grounded on the fourth amendment; the Supreme Court, mentioning rights under the federal securities statutes, had held that an implied private right of action can be based directly upon violation of the fourth amendment and had remanded for a determination of the immunity or defense to be available. Bivens v. Six Unknown Named Agents of the Federal Bureau of Narcotics, 403 U.S. 388 (1971). The Second Circuit decided that because constitutional search and seizure law is so dynamic, the interests of society, law enforcement officials, and suspects are best balanced if the law enforcement officials are allowed a defense upon showing both a subjective good faith belief and an objective reasonable belief that their conduct was lawful.

222 Securities Act § 24, 15 U.S.C. § 78x (1970); Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1970).

tion under the federal securities statutes.[223] A condition of disciplinary action in a broker-dealer proceeding is a finding of "willful" violation, but "willful" in that setting seems to mean only that the person was awake; some SEC opinions indicate that reasonable reliance upon counsel would not show lack of willfulness.[224] In an after-the-fact proceeding seeking to enjoin future violations, the reliance upon counsel's opinion would weigh heavily in the court's determination whether there is sufficient equity for the injunction.[225] In an injunctive action brought during the offering and seeking its termination, reliance upon counsel's opinion is seemingly immaterial because the issue is whether a violation continues.

In situations such as I have just described, a no-action letter issued upon an accurate and full disclosure of material facts by the client provides practical assurance that the SEC will not bring or recommend governmental action against the client. That concept could be expanded by providing that certain types of attorneys' written opinions will provide at least some assurance in the same direction. For example, our hypothetical broker-dealer who reasonably acted upon counsel's carefully considered written opinion, should, I think, have express assurance by SEC rules that no broker-dealer proceeding will be instituted against him and that no criminal proceeding will be recommended.[226] Equity actions raise different considerations. The SEC's right to bring an injunctive action before or during the course of a violation should not be diminished by counsel's opinion and an after-the-fact equity action can often lead to useful receiverships or restitutionary payments of the type required in *Texas Gulf Sulphur*.[227]

In fashioning rules concerning reliance upon counsel's opinion, should the laconic, clean opinion be preferred over the opinion expressing in one form or another the unsettled state of the law and an estimate of the probable outcome if the matter were litigated and concluding perhaps only that success would be more likely than not? The attorney might prefer the latter form and the client might find it useful in deciding whether and how to proceed where the law is unsettled. Equal treatment of the two forms would tacitly encourage transactions to proceed when the attorney expressly indicates that he will opine only, for example, that it is more likely than not that the courts would hold an exemption is satisfied.

In fact, most persons probably now so interpret all securities opinions

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[223] Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901, 951-53 (1971).

[224] *Cf.* Handly Investment Co., SEC Exchange Act Release No. 7438 (Oct. 9, 1964); *see* Cornelis de Vroldt, 38 S.E.C. 176, 180 (1958); Wolfson & Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 STAN. L. REV. 603, 607 (1972).

[225] SEC v. Harwyn Industries Corp., 326 F. Supp. 943 (S.D.N.Y. 1971).

[226] *Cf.* note 193 *supra* and accompanying text.

[227] SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971).

in an unsettled area, and a candid, explicit estimate of uncertainty (and hence the certainty) should not be discouraged.[228] Furthermore, persons acting in good faith reliance on such an opinion prepared with due care should not be considered "willful" violators if a violation is found. The Supreme Court's 1971 decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*[229] continues the doctrine that the securities statutes are to "be read flexibly, not technically and restrictively."[230] Remedial construction of the securities statutes has created uncertainty as well as an effective set of investor protections. To hold that one proceeding in the face of a known substantial uncertainty in the statutes and the SEC's rules commits a willful violation if it is later decided that his lawyer did not draw the line at the right place would make the remedially construed statutes unworkable.[231]

VI. CONCLUSION

In his famous speech delivered in 1934 at the dedication of the University of Michigan Law Quadrangle, Justice Stone spoke of the Bar's role in the massive management deviations during the 20's and early 30's from the fiduciary principle:

> There is little to suggest that the Bar has yet recognized that it must bear some burden of responsibility for these evils. But when we know and face the facts we shall have to acknowledge that such departures from the fiduciary principle do not usually occur without the active assistance of some member of our profession, and that their increasing recurrence would have been impossible but for the complaisance of the Bar, too absorbed in the workaday care of private interests to take account of these events of profound import or to sound the warning that the profession looks askance upon these, as things that "are not done."
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> We must remember, nevertheless, that the very conditions which have caused specialization, which have drawn so heavily upon the technical proficiency of the Bar, have likewise placed it in a position where the possibilities of its influence are almost beyond calculation. The intricacies of business organization are built upon a legal framework which the current growth of administrative law is still further elaborating. Without the constant advice and guidance of lawyers business would come to an abrupt halt. And whatever standards of conduct in the performance of its function the Bar consciously adopts must at once be reflected in the character of the world of business and finance. Given a measure of self-conscious and cohesive professional unity, the Bar may exert a power more beneficient and far reaching than it or any other non-governmental group has wielded in the past.[232]

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[228] *Cf.* note 193 *supra* and accompanying text.

[229] Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

[230] *Id.* at 12.

[231] *Cf.* note 193 *supra* and accompanying text.

[232] Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 9-10 (1934).

In *Garner v. Wolfinbarger*,[233] easily the most important single development discussed in this article, the court did not refer to Justice Stone's speech, but the same concern for the impact of management derelictions upon the public and the importance of the best use of attorneys' advice and influence to guide toward compliance with society's norms (especially legal ones) was manifest. Many of the current uncertainties facing lawyers arise because the courts and the SEC are acting upon Justice Stone's observations.

The lawyer's role in securities regulation is so central that his actions cannot and will not be left to lawyers alone to regulate. What lawyers do or fail to do will in large measure determine the level of compliance with the securities statutes. These truisms will not, however, answer the hard questions discussed in this article. Lawyers do represent clients, not society at large, and the interests of the two sometimes conflict. But who are the clients when counsel represents an entity? When, despite additional costs, do we want to force the attorney to verify the client's version of the facts before he issues an opinion that may unleash upon investors securities with an infirm disclosure base? How should the attorney and his clients proceed in the face of unsettled legal questions, which seem to abound in the remedially construed securities statutes? An SEC rulemaking proceeding is a preeminent forum for resolution of these highly practical questions, which now present themselves in lawsuits rather than speeches.

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233 Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971).